Reimagining Capitalism

What is capitalism? Is it the greatest source of prosperity and freedom the world has ever seen or a menace on the verge of destroying the planet and our society? Rebecca Henderson argues that capitalism is the only solution to the massive problems that we face and explores the ways in which the private sector can help to reimagine capitalism so that it works for everyone.

Rebecca Henderson
Harvard University

Capitalism is one of the great inventions of the human race: an unparalleled engine of prosperity, innovation, and individual freedom that has lifted billions of people out of poverty. In 1910 1.75 billion people lived in extreme poverty – now, though the world's population has more than tripled, only about 0.7 billion do. In the 1950s half of the population lived on less than $2 a day. Now it's only 13 percent. In 1820, 43 percent of the global population died before the age of five. Only 4 percent do now.

But in many places inequality has climbed to levels not seen since the 1920s. In the US and the UK those at the bottom of the income distribution have not had a significant pay raise in the last twenty years. Social mobility has fallen dramatically: the odds that children born today will make more than their parents is now less than fifty percent. Across the world, minority populations continue to be largely excluded from the economic mainstream. In the US, for example, the average median household income for Hispanic people is 70 percent that of whites, while for Black people it is less than 50 percent.

At the same time, the planet is warming. Left unchecked, global warming threatens to destabilize the climate, squeeze the world's food supply, flood many of the great coastal cities and force millions of people to migrate. One million of the world's eight million species are faced with extinction, while the burning of fossil fuels continues to cause enormous

damage to human health every year. Emissions have fallen (slightly) in the face of the COVID-19 pandemic but they are poised to bounce back hard and fast.

> We have allowed our societies to get radically out of balance.

What happened?

The problems we face have many causes, but one of them is that we have allowed our societies to get radically out of balance. In the 1970s and 80s, economic development was guided largely by the Washington Consensus, a view that focused overwhelmingly on the power of free markets to drive growth. Because of the Consensus, influential bodies such as the World Bank and the IMF pushed developing countries to embrace far-reaching deregulation and privatization, and to open their domestic markets to global trade and free capital flows as routes to development, without explicit attention to the health of local political or social institutions. Beginning in the 1990s, however, this strategy was increasingly challenged on both empirical and theoretical grounds.

Many states that adhered to the Consensus failed to do as well as expected. In post-Soviet Russia in particular, the rapid liberalization of markets was followed by a descent into crony capitalism. Meanwhile, the so called "Asian tigers"—especially Taiwan, Singapore, and South Korea—succeeded economically by pairing market development with heavy government intervention.

It became increasingly clear that the rule of law, well-designed corporate governance, anti-corruption safeguards, democratic government, a free media, and appropriate financial regulations are critical to enabling free markets to stimulate high quality development. Scholars came to distinguish between "inclusive" and "extractive" societies. Extractive regimes concentrate both political and economic power in the hands of an elite few. Healthy inclusive societies, by contrast, rest on three foundations: a free market; a strong civil society; and a democratically elected, transparent, capable, and responsive government. Together these three institutions hold each other accountable, balancing the power of the free market with the need to provide public goods and the need to ensure that the market remains both free and fair.

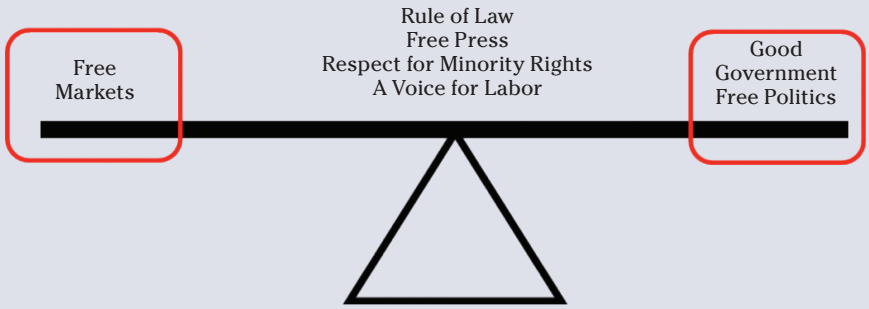
In the US, in the 60s and 70s, this balance was broadly understood. Businesses saw themselves as partners in generating prosperity that benefited everyone. But by the early 80s, managers in much of the developed world had begun to believe that their sole responsibility was to increase profits, even if that meant dumping greenhouse gases into the atmosphere, driving wages so low that employees were forced to depend on government support, and lobbying for rules and regulations that favored only themselves.

This belief in profits alone arose from a transformation in economic thinking pioneered by Milton Friedman and his colleagues at the University of Chicago following World War II. While many of their arguments were highly technical, the intuition behind them is straightforward. They first suggested that the efficiency of free markets makes them a spectacular driver of economic prosperity. In truly competitive markets booming demand triggers the kind of innovation and entrepreneurship that produced smartphones and Airbnb, while competition forces down their prices. Second, Friedman and his colleagues argued that by opening up economic opportunity to anyone, regardless of family, color, or creed, free markets allow people to control their own destiny, building political power. In their view building a functioning democracy in a state that controls who you work for and how much you're paid is difficult, if not impossible. Third, the Chicago economists held that managers work for their investors and not for themselves. Since investors generally want to make as much money as possible, managers who did anything other than maximize returns were therefore indulging themselves at their investors' expense and betraying their investors' trust.

Collectively, these arguments implied that doing anything other than maximizing profits – - to charge less than the market will bear for a lifesaving drug, for example, – was not only to abandon your duties as your investors' agent but also to make society poorer and less free.

Initially, this approach appeared to be a way of organizing society

Figure 1. The three pillars of a strong society.



that delivered all that it promised. In Asia, Eastern Europe and South America, for example, many nations that adopted free market thinking saw explosive economic growth and increased political freedom. China's embrace of free markets brought more than a billion people out of poverty. Successful managers and entrepreneurs like Bill Gates, Steve Jobs, and Mark Zuckerberg became cultural heroes.

> It became increasingly clear that markets require adult supervision.

But as the economy flourished, the world around it did not. It became increasingly clear that markets require adult supervision. Markets only lead to prosperity and freedom when they are genuinely free and fair. Intuitively, if firms can dump toxic waste into rivers, lie to their consumers, and form alliances to fix prices, there is no guarantee that maximizing profits will increase either aggregate wealth or individual freedom.

It's also important to remember that Friedman and his colleagues first formulated their ideas in the aftermath of the Second World War. At the time, there appeared to be a serious risk that a reliance on the market would be replaced by centralized planning. Government – after conquering depression and war – was popular and powerful. Capitalism, in contrast, was not. In the developed world at least, the state could be relied upon to ensure that markets were reasonably competitive, that externalities such as pollution were appropriately priced or regulated, and that (nearly) everyone had the necessary skills to participate in the market. Moreover the experience of fighting the war had created immense social cohesion. Investing in education and health, "doing the decent thing," and celebrating democracy seemed natural. Under these conditions, it was not unreasonable to believe that "unleashing" the market by telling managers their only job was to increase shareholder returns would, in turn, maximize both economic growth and individual freedom.

But in the last seventy years the world has changed almost beyond recognition. Institutions that have historically constrained the market are under attack across the board. In many countries people no longer feel a sense of common identity. Instead we are increasingly divided by racial, ethnic or religious loyalties and by basic worldviews. Governments everywhere are increasingly unable, or unwilling, to focus on the long term or on the well-being of the entire community. In the developed world, politics is increasingly deadlocked, fragmented, and angry. Meanwhile many governments in the developing world are corrupt. And although our problems are global, we have few effective global institutions.

> Left unchecked, markets are subject to powerful incentives to destroy the natural and social worlds around them.

In short, global capitalism looks less and less like the textbook model of free and fair markets enabled and controlled by civil society and democratic government on which the injunction to focus solely on profit maximization was based. It's not surprising, then, that we are increasingly neither prosperous nor free. The U.S remains the richest nation on the planet, but the income and wealth of most of the population hasn't increased in over twenty years. At the same time, we are destabilizing the climate and poisoning the sea.

Our fixation on maximizing shareholder value is actively making things worse. As long as the private sector's untrammeled pursuit of profit at any cost took place within strong, well governed societies, it created enormous value. But left unchecked, markets are subject to powerful incentives to destroy the natural and social worlds around them.

As a result, the responsibilities of firms have changed dramatically. The deepest moral commitments of capitalism require that they help to sustain the health of the institutions on which the free market relies. If firms exist to maximize prosperity and social welfare, they have a moral duty to act as if there were a price for carbon, for example, even when there is no price in place. If firms exist to maximize freedom of opportunity, they have a responsibility to invest in health care and education, or to persuade the government to do so. The first step towards reimagining capitalism is thus not to abandon shareholder value but rather to embrace the idea that firms also have a duty to support the health of the natural, social, and institutional systems on which capitalism relies.

What can be done?

Without rebuilding our governments and our societies, we will not solve the problems we face. We need to mobilize people around the world in a massive political and cultural movement that demands that we stop heating the planet and destroying the ecosystems we depend upon, that insists on the widespread provision of education and health care, a genuine voice for labor, real racial inclusion, and the kind of redistributive taxation that would ameliorate the worst effects of inequality.

But business also has a central role in building a just and more sustainable world. Governments

are national, while our problems are global. Politicians tend to focus on the short term, while we need to focus on the long. Waiting for governments to act is ever more clearly a recipe for disaster. Business is arguably the most powerful institution on the planet. Only firms can drive the innovation we need at a scale that can solve today's environmental problems and generate the jobs upon which decent lives are built.

Business has a compelling economic reason for solving the big problems.

The good news is that business has a compelling economic reason for solving the big problems. It will be much easier to make money in a world in which the climate is relatively stable, in which the coasts are not underwater and in which agricultural collapse is not routinely triggering the migration of hostile, hungry populations. Moreover the private sector benefits from a world with significantly less poverty and inequality. Societies that have reduced inequality and poverty have generally increased access to education and capital and, through some combination of minimum wage laws, lowered entry barriers, and organized labor representation, maintained relatively high wages while using tax revenues to ensure that no one is left too far behind.

Throughout history, many firms have opposed these kinds of measures. The East India Company was a legally entrenched monopolist and fought tooth and nail to maintain its position, corrupting English politics for nearly a hundred years. Very few firms have actively campaigned for higher taxes, stronger unions, or increased social spending. But there is overwhelming evidence that the private sector as a whole is much better off in more open and more equal societies.

Countries governed by corrupt oligarchs can grow very fast and within them, individual companies can do very well. In Nigeria, for example, between 2006 and 2015, an extractive government that catered to oil interests (and received massive kickbacks from their operations) saw its GDP grow at an average of 7.6 percent per year. Likewise Turkmenistan, which harshly repressed religious and political freedom, grew at 11 percent. In a weak economy, small reforms can unleash significant potential, but growth under crony regimes is highly unstable and often stalls once the economy approaches the global production possibility frontier. Genuinely open markets, well established property rights, and a free media provide a much stronger foundation for new entrants and for the kind of creative destruction that generates substantial value. Widespread access to education and health care accelerates this virtuous circle by creating deep pools of talent and strong domestic demand. In states with inclusive institutions, GDP per capita has historically been much higher than in states with extractive institutions, and the gap has broadened over time.

The economic case for solving big problems is therefore reasonably straightforward. It is nonetheless a collective case and operates at the most basic level. It may therefore seem unlikely that any but the most visionary and confident business leaders would attempt to act on it. So what are some practical ways in which the private sector can respond to these incentives and, in so doing, both make a difference and meet their responsibilities to their investors? Could these actions in turn add up to real change?

Walmart saved about $1bn a year by redesigning its trucking fleet to reduce energy use.

It seems likely that the current move towards shared value, or towards the simultaneous creation of private profit and public benefit, is a critical first step. The evidence that there are broad opportunities to create shared value is extensive. Walmart saved about $1bn a year by redesigning its trucking fleet to reduce energy use. An alternative meat company recently became the most successful $200m+ IPO of the last twenty years. And Tesla is well on its way to becoming the world's most valuable automobile company. Firms that adopt high road employment strategies, which create jobs that pay well, treat employees with dignity and respect, grant them significant discretion to shape their own work, and build a collective sense of purpose, have repeatedly found that the strategy creates significant economic value.

Although such actions are sometimes derided as greenwashing or dismissed as too small or local to have any real impact, they often drive broader change. In the first place, they act as demonstration projects: proving that a private business can solve a public problem, driving the technology along the learning curve, demonstrating that new business models are feasible, and helping to develop a network that new entrants can use. Solar and wind power have both become multi-billion-dollar businesses and, in many parts of the world, renewable energy is now cheaper than conventional fossil fuels. Although we still face significant barriers to decarbonizing the world's energy system, it now appears that it can be done at reasonable cost, given the right regulatory environment. Ten years

ago that was not at all clear, and without the enthusiastic and active participation of the private sector, we could not have advanced so far. In agriculture, firms at the leading edge are demonstrating how much more profitable sustainable farming can be than more conventional techniques. For example, when Unilever committed itself to make 100% of its branded tea sustainable, demonstrating as it did so that the yields from sustainable production were often significantly higher than those of conventional production, every other major branded tea company followed suit, tipping the entire industry towards sustainable production. Innovations of this kind often strongly affect consumer attitudes as well, increasing demand for more sustainable products.

In the second place, firms can drive change through coordinated action. While there are many opportunities for firms to make money and address social or environmental problems at the same time, there are also many opportunities that can only be exploited if firms act together. The move to preserve the world's fisheries is a prime example. While every firm will benefit if everyone reduces their catch, no single firm can profit from doing so alone.

Many fisheries could be almost completely regenerated within a couple of years.

In principle, an industry in such a position can both increase its profits and generate significant social benefits by choosing to self-regulate. Many fisheries can be almost completely restored if they are given a couple of years to recover. Fisherpeople who can jointly agree to restrain themselves in the short term will usually find themselves much better off in the long term than those who cannot. Indeed, right now, nearly half the world's fisheries are governed by some form of self-regulatory arrangement. Cooperative arrangements to tackle the twin problems of sustainability and unacceptable labor practices have also emerged in cocoa, palm oil, beef, timber, and soy, while similar agreements are underway in the textile and IT industries and in mining and minerals.

In some cases, these voluntary self-regulatory arrangements have been extremely successful. The International Chamber of Commerce, for example, is an entirely voluntary body that regulates the world's trade, while cooperative arrangements significantly reduced deforestation in the Brazilian Amazon for many years. But these efforts are often unstable. Without any real penalty for failing to cooperate, firms are often tempted to renege on their commitments and revert to business as usual.

A very large fraction of the world's financial assets are controlled by roughly twelve firms.

Who – or what - might be capable of enforcing cooperation between firms, essentially forcing them all to do the right thing and leaving no one at a competitive disadvantage if they do? There are two possibilities. The first is investors. A very large fraction of the world's financial assets are controlled by roughly twelve firms. These firms are so large that they cannot diversify away from the threat of catastrophic risks such as climate change. Some of the world's wealthiest owners are similarly exposed. The Japanese government pension fund, for example, is worth more than $1.6 trillion and owns roughly 1 percent of the world's equity markets. Hiro Mizuno, who was its chief investment officer until early 2020, came to believe that solving problems like social inclusion and climate change was central to his fiduciary duty because they posed severe risks to his long-term returns.

The emergence of ESG metrics (Environmental, Social, and Governance) could give investors the means to insist that firms tackle environmental and social problems, and to track their performance as they do. More and more, investors are working together to push the firms they own to address both social and environmental risks. For example, more than 450 investors, representing $40 trillion in assets, have banded together to form Climate Action 100+, a group devoted to pushing the world's 100 largest emitters to set concrete targets for reducing carbon emissions and transitioning to a carbon free economy.

The second institution that might force firms to do the right thing is, of course, government. If governments worldwide regulated or priced carbon emissions, for example, it would be in every firm's economic interest to solve climate change. If governments strengthened labor regulations, making it illegal to pay any worker less than a living wage, if they invested heavily in education and health, actively supported employee organization and aggressively taxed the wealthy, inequality would fall. If it were illegal for corporations to flood the political system with money and if anti-trust regulations were routinely enforced, the largest and most powerful firms would be much less able to shape the rules of the game in their own favor.

Could it happen?

Could business actually help to rebuild our institutions? Businesspeople are already coming

together to lobby in favor of carbon regulation and against money in politics. We Are Still In, for example, brings more than 2,000 firms together with NGOs, faith communities, and city and state governments to lobby for pollution reduction targets which will allow the US to comply with the Paris climate agreement. In cities across America, local firms are working with civil society and city governments to improve the health of their communities.

In the current environment it may be difficult to imagine the business community lobbying for a wholesale rebuilding of the institutions of an inclusive society, but it has happened before. In the English Civil War of 1642-1649 and the Glorious Revolution of 1688-1689, a substantial middle and upper class bourgeoisie worked to usher in democratic reforms. More recently Germany's private sector played an important role in developing Germany's current institutions, working collaboratively with organized labor to develop a system of apprenticeship training that is often cited as one of the central determinants of the country's low inequality and high productivity. And an expanding body of research suggests that in South America the private sector has sometimes played a positive role in supporting democratic transitions, while the struggle to dismantle apartheid was strengthened by British commercial concerns about the system.

Could it happen again? Could the private sector play a central role in rebuilding our democracies? Should it? It might seem an unlikely idea. But ask yourself – what is the alternative? If business stays silent, focused on profit alone, what will happen? The COVID-19 pandemic has given us a profound opportunity to rethink our society and our institutions. We must seize the chance to reimagine capitalism. ■

For Further Reading

If you enjoyed this article you might enjoy Professor Henderson's recently released book:

Reimagining Capitalism in a World on Fire published by Hachette/Public Affairs, 2020

Rebecca Henderson is one of Harvard's twenty-five University Professors. She is a research fellow at the National Bureau of Economic Research, and a fellow of both the British Academy and of the American Academy of Arts and Sciences. She is an expert on innovation and organizational change. Her most recent book is "Reimagining Capitalism in a World on Fire" (Hachette/Public Affairs, April 2020). She was named one of three Outstanding Directors of 2019 by the *Financial Times*.