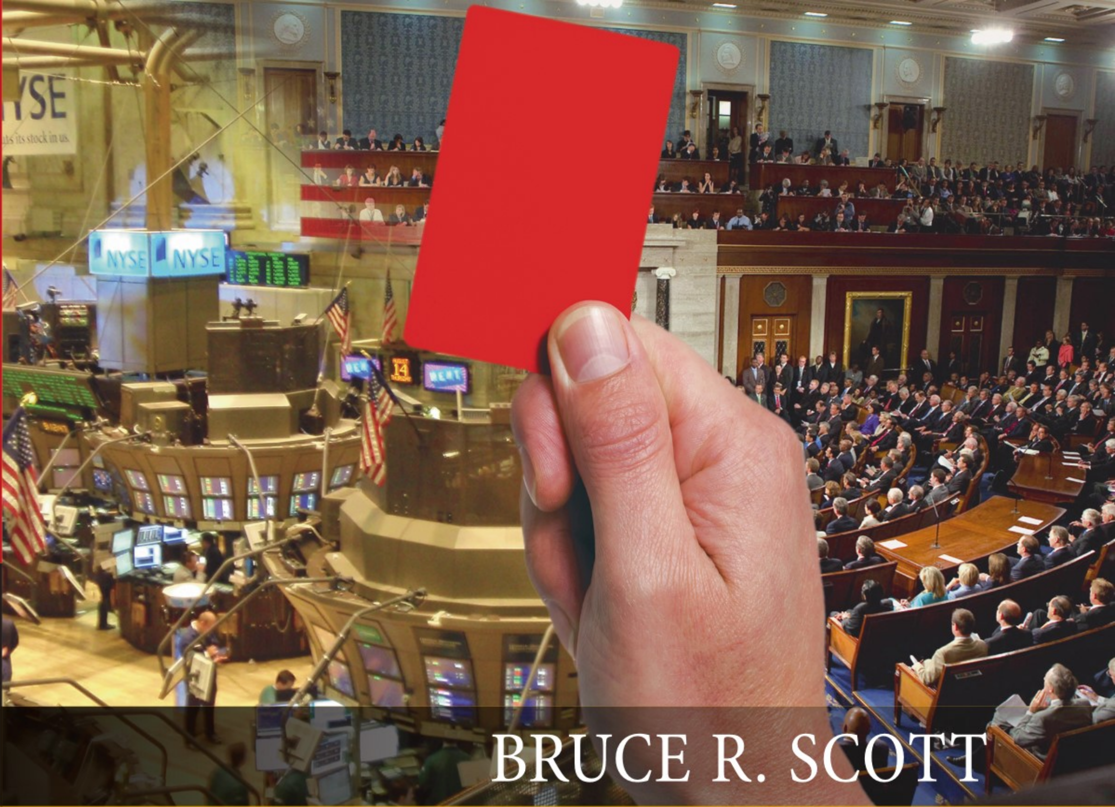

BRUCE R. SCOTT

CAPITALISM

Its Origins and Evolution as a System of Governance

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Bruce R. Scott
Paul W. Cherington Professor Emeritus
Harvard Business School
Boston, MA 02163
USA
bruce.scott8@hotmail.com

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Preface

This preface is a story of how this research was conceived and executed, false leads and all. For those who wish to move directly to an organized and logical introduction to my explanation of the origins and evolution of capitalism without this history, I suggest you skip this Preface and turn directly to the Introduction in Chap. 1.

This book began, some 20 years ago, as a study of comparative economic strategies. Initially, I was hoping to identify and evaluate the economic strategies of countries in terms of how they were defined (if at all), how they were implemented, and how well they had performed through time. In 1990, as at the present time, there was no recognized notion of country strategies; indeed there were high-status economists who said that such an idea was a complete misunderstanding of economics. Hopefully, the new Varieties of Capitalism literature will help broaden the perspective of those who have held the view that economics presents a universal, context-free, "consensus" model for development, which has little if any need for the visible hand of government in formulating or implementing an economic strategy.

Then, as now, there was no generally accepted definition of capitalism, and most authors seemed content with the notion that capitalism was what firms did in markets; a concept based on the study of firms and product markets, with little or no recognition of the special role occupied by factor markets (for land, labor, finance capital, or the chartering of firms) and still less recognition of the political economy of governance. Lacking such a definition after about 150 years of usage, it is not surprising that there was little consensus on where or when capitalism had originated or how it might have evolved. Some approaches to the study of capitalism found its origins to be coextensive with the development of trade, and thus with multiple geographic locations in pre-Columbian times. A second view, and arguably a very influential one among US economists, was that capitalism is a self-regulating system based upon voluntary transactions among consenting adults. This view, which has drawn little benefit of any historical perspective, is perhaps best exemplified by Milton Friedman and the Chicago School. A third view made capitalism almost coextensive with the Industrial Revolution, a view which equated capitalism with technological progress but which, like the other two, gave little or no attention to governance.

However, as I began my research these differences and indeed any problems in the literature on capitalism were not apparent to me; I was not planning to research capitalism and was unaware whether it could be an operational concept with a clear meaning. This preface is an account of the evolution of the research focus of this book from its inception, when I was preoccupied with the economic strategies of countries, to its final formulation, as an original account of the origins and evolution of capitalism based upon an original definition of the term as an indirect, three-level system of governance for economic systems.

The scope and purpose of the research underwent a profound change after a fortuitous trip to China. This preface is a recollection of some of the milestones in that research journey. As I did not keep much by way of notes on the process, it is a retrospective and necessarily incomplete and only approximate account.

My original plan had been to use the familiar business concept of economic strategy as a research tool to explore and interpret the activities of countries, rather than firms. I defined a national economic strategy as how a government, either directly or indirectly, influenced the mobilization and allocation of the resources of a society in order to enhance its prospects for growth and development, as a parallel to the experience of firms with their strategies. I settled on this topic and research approach for three reasons: first, strategy was the research framework that I had learned at Harvard Business School, starting in the General Management Area in 1959; second, it was a framework that I had used for approximately 30 years for research and teaching, including in an elective course called Economic Strategies of Nations; and, third, as the research was underway a new literature was just appearing that has since come to be known as Varieties of Capitalism. It gave external recognition to the idea that all societies or countries have strategies, however implicit or misguided those strategies might be. In the language of this book, the institutions and policies adopted by a country tilted its markets to favor certain segments of its economy or certain societal groups or purposes over others, and that tilt inevitably amounted to an implicit strategy. The notion that there was no such tilt was highly unlikely anywhere, but even if achieved it too would be a strategy. It was not a natural situation. Thus, my starting point was the belief that the formalities of neo-classical economics, with their emphasis on economic coordination through the impersonal price mechanism, without the visible hand of political governance, was not an adequate framework for understanding economic development anywhere, a viewpoint that would take great support from the work of Douglass North from 1993 onward, as discussed in Chap. 2.

In 1994, when I was about 4 years and 10 chapters into a book on economic strategies and how they influenced economic performance, a chance event led to a radical change in my research plans: I decided to travel to China, where my brother Douglas was stationed as the first Resident Representative of the International Monetary Fund, in Beijing. Given the nature of the opportunity provided by such a trip, I thought it best to stop what I was doing and assemble and explore a considerable reading list on the history of Chinese economic and political development. My wife Grenelle joined me both on the year-long background reading and on the month-long visit. Once in China we were very fortunate to have the help and guidance of Robert Chen, a Chinese-American entrepreneur and participant in Harvard Business School's Owner/President Management Program, with an operation in Shanghai and another in Los Altos, California. Bob became our guide as well as interpreter for 5 days in the Shanghai-Wuxi region. In the course of our discussions with mayors, deputy governors, and managers of firms, it became clear that the Chinese had quite a different variety of capitalism from the familiar US variety. Most obviously, Chinese government officials at the provincial as well as township and village levels were very much involved in the formulation and implementation of strategies. The Chinese were picking experienced scientists and engineers to be governors and mayors, after having first asked them to manage firms. While the Chinese had opened their markets significantly, their remarkable growth progress was not based on American-style free markets. There were unmistakable signs of top-down management by people who had the energy, the skills, and the power to change the course of events, e.g., the "visible hands" to implement an economic strategy. The notion that the Chinese miracle was powered by the opening of the markets, as in the neo-classical paradigm, was at best a half-truth.

After the trip and the readings, one book stood out for its influence on my thinking: Fernand Braudel's three-volume *History of Civilization and Capitalism, 15th Century to the 18th Century*. In the third volume, Braudel noted something that was completely new to me, to wit that average incomes circa 1500 were relatively equal across the most settled areas of the world at the time, which I took to mean Japan, China, India, present-day Turkey and Iraq, and Europe. The spread between the high- and low-income areas was estimated to be about two-to-one. Yet by the time I was doing my reading in Braudel, that spread had broadened to approximately thirty-to-one because of growth in the high incomes. This increased spread in relative incomes and therefore economic performance raised some immediate questions; for instance, what was it that had led to the rise of Europe, in relative terms, from circa 1500 onward? In hindsight it seems supremely ironic that Braudel was never able to ask if what he was searching for might have been hidden right in front of him, in the title of his book, i.e., in the European creation and adoption of an early concept of capitalism as a system of governance for many, but by no means all of their respective economies. Braudel was never able to define capitalism, as he readily admitted in his second volume, and, perhaps as a consequence, he never considered the possibility that the key to the relative rise of European incomes might have lain in the creation of that capitalist model of governance.[1] Indeed, Braudel did not go looking for a model of governance; instead, he seems to have been looking for some natural force or forces that would explain the relative progress of Europe. What, he asked, was the "yeast" that led to the rise of Europe, circa 1400–1800?

From my vantage point, the rise of England, the Netherlands, Portugal, and Venice could be explained in terms of the strategies that I was looking for: all had adopted mercantilist strategies of economic development by the 18th century, and

[1]See Fernand Braudel, *Civilization and Capitalism, 15th–18th Century*, trans. Siân Reynolds, vol. 2, The Wheels of Commerce (Berkeley: University of California Press, 1982), 231.

in the case of Venice much earlier. Most of my early chapters were case histories on the early development of these societies, e.g., in the 17th century, which served as building blocks for a theory of purposive growth led by economic strategies. The idea was to use the notion of their respective strategies to explain the inequalities. However, Braudel's search for a single ingredient, a leavening agent, and his failure to find it led me to reexamine my own search for an explanation of economic growth and prosperity in the economic strategies of ascendant and prosperous societies. I began to think that a much more complex interactive process of mobilizing and allocating resources would have been required to give rise to the prosperity of these societies.

After visiting China, the puzzle of its decline, between 1400 and 1800, and the period of Europe's rise, was on my mind. Braudel and others had pointed out that China had occupied a position of arguable economic leadership circa 1400, only to fall to virtual last place by 1800, where it remained for more than 150 years. How could China have fallen behind and remained a laggard? This puzzle was all the more interesting because China had the largest population and by far the largest home market, thanks to an unparalleled inland system of waterborne transport through some 30,000 miles of canals. In addition, it had an advanced form of bureaucracy, and a stock of technologies, which, though perhaps not the match of Europe, nonetheless had many successful exemplars of its own, and was far more sophisticated than any society in the Western Hemisphere or Australasia. And yet Europe, North America, and Australia would pull ahead of China and remain ahead for centuries.

Strategy hardly seemed a promising way to understand what the Chinese had created and then apparently lost. It similarly seemed a weak way to try to explain events in India, Japan, and the Ottoman Empire. These great Asian civilizations had been relatively safe from foreign takeover and thus had little need for an effective strategy until confronted by European colonialism in the 17th century. Was it just coincidence that each of these empires was characterized by highly centralized government with rigid bureaucratic controls that stifled innovation? Was it relevant that many of their advantages, including technological advantages, were monopolized by those at the top of their societies and thus of little benefit to the bulk of their populations? For instance, where Europeans were quick to utilize clocks to permit more efficient use of time by the residents of their cities, Chinese emperors were able to enjoy near-monopolies of the time keeping technologies for their astronomy and astrology, at the expense of their own people. Still more to the point, *why* had it happened? Maybe competition and even adversity could be advantageous or even essential conditions, for inducing the effective mobilization of human energy and motivation as well as more tangible resources. Was external competitive pressure an important precondition for effective strategy and/or governance, as it seemed to be in the case of the leading European states? Was it missing virtually everywhere else at the time?

The relative economic decline of a number of the major economic powers in the period 1400–1800 challenged the adequacy of my research framework and led me to return to the history texts that I had encountered as an undergraduate at Swarthmore

College in the 1950s. In so doing I rediscovered writings on the great European advantages that I had encountered in a course in Modern European History with Professor Mary Albertson: those readings pointed to "good government" based on limited monarchy (i.e., not democracy), the Enlightenment (or the resort to human reason as the ultimate source of authority), and continuous competition among a number of states of relatively similar size, rather than the top-down *dirigisme* of the lead powers of the time, whether France or Spain. However, the survival of the smaller powers depended upon the British policy of maintaining a balance of power: Britain acted like an antitrust enforcement authority. These analyses, however, shared Braudel's weakness of having little by way of operational models to explain how countries or empires either managed or mismanaged their development.

These issues of societal development were simply too broad for me to analyze until I began to think of two countries, Italy and the United States, each of which hosted two distinctly different regions, with the northern region emerging as the more developed. Why, in both of these examples, had the north of a country done much better than the south, and for more than a century at a time? Research Associate Jamie Matthews worked with me to create two case studies on Italy, one for the period prior to 1980, and one from the 1980s on, to study the effects of patron–client relationships, and especially in the southern or Mezzogiorno region. She then drafted a companion case study of the US post-Reconstruction (1870), which looked at the history of a segregated South in a democratic society, and its comparable experience with the distortions caused by the patron–client relationships of racial segregation.

These cases, exemplars of an idea the Chinese had called "one country-two systems," shifted my focus toward politically defined regional governance and, inevitably, to the importance of political structures and governance. All countries had regions and regional differences; what was special about these particular regional examples? For one thing, they demonstrated that governance systems did not spread their influence gradually, like trade. A state or regional boundary could demarcate a distinct political system for centuries, free-trade and free-capital movements to the contrary notwithstanding. China was a case in point; it retained quasi-feudal property rights until 1978 and even beyond, a system the French had abandoned in their Revolution 200 years earlier, in a shift that opened the way for capitalism in a land known for its top-down *dirigisme*.

It was at about this stage that Braudel's metaphor of a yeast-like ingredient leading to the "rise" of Europe fell apart for me. Braudel had related Europe's advantages to the growth of cities and towns ahead of many other areas; in his metaphor, the cities were not just the high-income areas in Europe but a key source of growth; their roads and markets were like the yeast that allowed Europe as a whole to rise to take the lead in economic growth. However, Jamie's search of historical records showed that the Ottoman Empire had larger cities than any in Europe (e.g., Istanbul), and China had larger cities still. Cities were where growth took place, but were they the principal causes of that growth?

Cities could grow on the basis of tax revenues collected as a result of compulsory payments to central governments. These tax payments might accrue in their national capitals, as rising per capita incomes for civil servants and others, in which case they were a reflection of the use of wealth and not its generation. Alternatively, a city's wealth could be derived from revenues generated by trade, for example, in seaports such as Istanbul or Venice.[2] Only growth from the latter would be indicative of new wealth that might promote further growth. While Italy had the highest incomes from 1400 to 1700, that wealth was concentrated in mostly modest-sized cities, in the north and center, and was attributable mostly to trade. Cities themselves could induce growth, but they did not necessarily do so. Palermo and Naples were formerly powerful Italian cities that had been co-capitals of the Kingdom of the Two Sicilies that had been in none too graceful decline since the 13th century. What were they missing?

If there was something like yeast at work in Europe, it must have been in units larger than cities, i.e., in states or empires. It took several more years to understand the role of states in development, and then of the role of competition among the states as a spur to development. This uncertainty of how states might be an essential element in the wealth generation process drove me to reexamine how I thought about governance. My training had been based upon the notion of strategy for the mobilization and application of resources for wealth generation, and of organizational structure for its control and utilization, as the operational concepts for understanding the development of firms. However, there was no clear idea of governance in the model. The model was built on a "managerial" model of capitalism whose roots were in Alfred Chandler's classic work *Strategy and Structure*, and subsequently developed in his prize-winning *The Visible Hand*, where the roles of the board of directors and the shareholders had not been fully developed. As a result, my ideas on corporate governance were much less developed than those on strategy, and they were if anything even less applicable to countries or societies. Creating a framework for understanding how countries governed their economies became the central intellectual challenge in this research.

Two important developments suggested a way forward. First, in 2000 I began to think of competition among economic actors (e.g., firms) in an economy as analogous to competition of teams in organized sports. I do not remember a particular moment when this idea occurred, and it took a number of tries to work out the three-level structure of organized sports before it could be applied to capitalism. As I worked out the sports analogy, I relied on Jamie to help me restrain my enthusiasm for the device until I was certain that it would hold up well to its task. The critical insight was to get beyond looking only or even primarily at the competition between two teams on a playing field in order to see an organized sport as a whole; with a political authority for its governance, and a set of rules for play monitored by appointed officials, whether the playing field accommodated two teams at a time, or 20, or perhaps 2,000. Capitalism has many competing teams,

[2] For example: Antwerp and Rotterdam were centers of trade; Istanbul was a center of trade as well as the capital of an empire; Madrid was a capital with little trade; and Rome was a former world capital with little trade or political power.

of very different sizes, but still the competition is based on a set of rules that apply to all and that are formally monitored for compliance, with regulatory decisions that are backed up by coercive force if need be. The capitalist parallel was to formally organized sports, not to informal sports played among family or friends in an unmarked field or a back yard. Informal sports were more nearly parallel to an economy based on barter. Europe presented itself as a uniquely fortunate natural experiment, with its 300–500 competing political entities in 1500; they were reduced to only 40 in 1820, paralleling the "shakeout" that routinely takes place in new industries in modern times. How was European political competition organized, if that was indeed the right term to use, and who had organized it and how? What were the keys to survival in such a context, and the costs of a takeover by a rival power?

Second, the notion of formal competition also called for recognizing the importance of legal systems, through which societies themselves were formally organized. I realized that those legal systems needed to be part of my analytic framework if I was to understand how and why some societies might outperform others. The underlying idea was that sports teams, and firms, and even entire societies were all open systems wherein a governing authority created a system of governance for its society and a strategy for enhancing the interests of that particular system in its environment, an idea that had been central to my doctoral thesis, "An Open System Model of the Firm."[3] All social systems could be looked at as open, and all could be expected to have emergent strategies and processes of governance for advancing their interests. However, these strategies and processes required the visible hand of human agency; they required powers of governance to modify their policies and institutions to improve performance instead of just adjusting supply and demand to achieve a new equilibrium. There was evolution in such a system, but it was not like biological evolution in the sense of allowing the environment to determine which varieties were naturally selected by that environment. Variety could be internally generated by the visible hands of political leaders, and a preferred variety could be selected and backed by resources mobilized by those visible hands. A human system could make purposive choices which might not be optimal in the short run, like taking a step backward in order to take three steps forward, a point made by Sumantra Ghoshal in his exceptionally perceptive paper, "Bad Management Theories Are Destroying Good Management Practices."[4]

Whereas systems theory taught me to recognize that all living things could be recognized as parts of one or more systems, it also taught me that it was of fundamental importance to be clear just which systems they might belong to, and to

[3]Bruce R. Scott, "An Open System Model of the Firm" (DBA dissertation, Harvard Business School, 1962).

[4]Sumantra Ghoshal, "Bad Management Theories Are Destroying Good Management Practices," *Academy of Management Learning and Education* 4, no. 1 (2005): 75–91.

analyze their activities in light of such systems. For instance, to understand capitalism as a system it was important to recognize that seeing capitalism as equivalent to the activities of firms in markets was a very shallow, incomplete notion of any such system. There needed to be recognition of rules of behavior and of referees to monitor and enforce those rules. On the other hand, the notion that all individuals could be seen as atomistic entities, unrelated to their surrounding human groups and the rules of behavior governing such groups, was clearly reductive. Convenient because it allowed all individuals to be classed as though they were essentially identical building blocks or atoms, like the basic particles of physics, yet each with rational expectations so that humans could be considered in isolation from one another, and without distinctive personalities, this expectation was and remains a gross oversimplification of reality and about as unscientific as it could be. It was the grist that was needed for mathematical model building, but not a good basis for understanding the behavior of people in organizations. Unrelated individuals could be expected to behave differently from tightly knit groups of the same size, even if the individuals looked and weighed about the same. Hierarchically organized groups could be expected to behave differently from others with a flat or egalitarian structure, and so on. Sociology mattered as well as political science, law, and economics. The traditional analytical tools of economics were not adequate to the task I had undertaken.

The Origins of Capitalism

It was at this stage that I began to experience some cumulative learning. Rivalry among states put a premium on military power, which, in the period from 1400 to 1800, depended on hiring mercenaries. The need for mercenaries made it clear that countries were *Sovereign, But Unequal*, which became the provisional title of the book.[5] Successful states could more easily afford to meet their need for mercenaries in order to avoid a "hostile takeover." Hostile takeovers in this political competition might be very harsh, often leading to the execution of political leaders of the old order. There was a huge incentive to raise incomes to increase the tax base to permit hiring more troops, i.e., to adopt a mercantilist strategy for defense if not offense. Europe was building its economic institutions, such as banks, paper currencies, and bills of exchange, in part to help develop its incomes and thus the tax base to finance defense. The efficiency as well as the legitimacy of these institutions depended upon their national legal systems, and not least on how well they protected creditors. A better credit rating for a society could reduce borrowing costs by as much as two thirds, which meant that a comparably sized country could support far more troops. So societies could have strategies and structures of governance to advance their interests, and size did not directly translate itself into power. As with firms, strategies

[5]See Bruce R. Scott, "The Great Divide in the Global Village," *Foreign Affairs* 80, no. 1 (January/February 2001): 160–177.

and structures made a difference. The Netherlands became a veritable powerhouse in the 17th century with only about one million people, thanks to a strategy that yielded a sound credit rating, low interest costs, and thus great borrowing power in case of an emergency, a set of circumstances I explore in Chap. 5.

But where was one to start an analysis of the evolution of systems as complex as whole societies? Fortunately, there were some remarkable lessons to be gleaned from examining the circumstances and results of the European settlement of the Western hemisphere, where virtually new societies were built from scratch, as if in a natural experiment. It was my good luck to encounter some remarkable research of Stanley Engerman and Kenneth Sokoloff, who had recently published pioneering work in analyzing this situation and explaining subsequent income divergence. Tracing alternative production systems and their implicit strategies and associated governance systems back to the factor endowments upon which they were built, Engerman and Sokoloff downplayed explanations based on European culture or legal systems, let alone distance from the equator. Instead, they found that rich factor endowments induced the development of characteristic production systems (based on forced labor) whose governance systems were also based upon force, and which overpowered other factors, such as the theoretical powers of a democratically elected parliament.

Jamaica was a particularly powerful example of the role of governance in development. In the 1700s it had British law formulated by a British-style parliament, but as a framework for the enforcement of slavery and not as a framework for individual development through the protection of civil liberties let alone for democratic governance. Jamaica's production system had a distinctive set of institutions based upon slavery, and slave-based systems seemed to be broadly similar whether governed by British, Dutch, French, Portuguese, or Spanish law. In the Jamaican case, British law was used as the basis for the ruthless repression of the black majority by a tiny white oligarchy, as explained in Chap. 6. An MBA education helped me see these relationships between the macroeconomy and the different production systems on which they might be built.

A similar logic applied in North America, but the demographics were different as well as the richness of the factor endowments. The initially higher incomes in the US South were also based on plantation agriculture, which depended upon slavery, where the system was devised and supervised by a tiny elite of English-speaking pseudo-capitalists. Governance systems that included slavery were the antithesis of capitalism: labor was not free to search out its most effective usage. Such systems led to underdevelopment of public goods such as roads and police protection, and, eventually, to underdeveloped education systems and underdeveloped human resources. British law could be used to enslave the inhabitants or to promote their freedoms; the key factors that shaped the fortunes of the various colonial regimes lay in the governance of their respective political systems and not in the legal systems per se.

Rich factor endowments in the South foretold the creation of exploitative production systems run for the benefit of privileged elites, and the policies and institutions created by these elites stunted the opportunities for most inhabitants, foretelling their eventual underdevelopment relative to the North. However, in the United States the slave populations rarely exceeded 20% of the total. In political terms slavery was always a minority proposition in the United States, and thus much less of a threat to democratic governance. The white settlers could expect to dominate in any of the states. In 2006, with this broadened scope of analysis and with the encouragement of the editor, I shifted the book's emphasis from strategy to governance and, accordingly, the title to *Capitalism, Democracy, and Development*. Explicit recognition of governance in the title came three years later.

The Evolution of Capitalism

The US economic histories that I read initially shared a weakness with Braudel's account of the rise of Europe: they overlooked human agency as an explanatory factor in the story. As Robert Lachmann noted of Braudel's magnum opus, the great master was satisfied with description, and that is not equivalent to explanation. Looking for explanations of US economic development and the rise of oligarchy during two separate eras, 1830–1937 and 1980–2009, I found mostly descriptions of those periods, as well as accounts of the interim period, 1950–1980, when a socially democratic United States more closely resembled Europe. The lack of explanation was less pressing in analyzing the first 200 years of development in the United States, circa 1630–1830, described by Research Associate Sarah Potvin in Chap. 7 because it is an iconic case study of the atomistic society explained by Adam Smith in his *Wealth of Nations*. But, initially, I was not able to provide the readings or ideas that Sarah needed to draft what is now Chap. 13.

I looked further afield, to my earlier experiences with US history at Swarthmore College. Some of the notions of US experience with oligarchy were familiar from my classes with professors such as Clair Wilcox, Joseph Conard, and Frank Pierson, all of whom were interested in economic history. In addition, some were anticipated in periodic discussions with my father, a graduate of the University of Chicago and its Law School, and a senior attorney for the Burlington Railroad. He came at the world from a much more conservative perspective than the Swarthmore faculty that I knew best. In addition, some of my ideas came from my mother, who had studied economics—or "commerce"—at the University of Chicago and worked there for perhaps 5 years afterwards as a researcher in the employ of a distinguished economist and future Senator, Paul Douglas.

However, the decisive role of human agency in the development of the United States in the 19th century was only brought to my attention through a chance conversation at the Faculty Common with Rakesh Khurana and Scott Snook, two sociology professors who were friends and faculty colleagues at Harvard Business School. In the spring of 2007, following many months of frustration studying economic histories that were largely passive descriptions, they pointed me to Charles Perrow's study of two different American developmental models early in the 19th century, one built around clusters of small firms, and the other permitting the growth of giants.[6] Whereas the work of Alfred Chandler had made the second model look imperative, Perrow argued, persuasively in my view, that there were decisions to be made by the entrepreneurs and also by legislatures, courts, and the executive branch of government, which had, in fact, shaped the US capitalist model.

When human agency is taken into account, the story of US industrial development in the 19th century becomes one of competition between those who wanted to empower firms to grow and become more productive and inevitably more powerful politically as well as economically, and those who wished to establish a regulatory framework to protect the public from the abuse of private power by those same firms, for instance, through regulation of railroad rates and/or by restricting the rights of firms to grow through mergers and acquisitions. If the development of the new technologies of the Industrial Revolution was on the side of empowerment of firms, the creation of regulatory agencies at the state level was supposed to be on the other side. But often it was not. For instance, the Fourteenth Amendment, which was originally passed to protect the rights of the recently freed slaves from abuse by state governments through the agency of due process of law, and federal law at that, was soon used to protect essentially white firms from regulation by those same state governments.

Here it gradually became clear to me that US capitalism was quite unlike any other, and in ways that were generally unfamiliar to educated Americans, including those who received MBAs from US business schools. The powers of the US government to regulate the activities of US firms might well be far weaker than the corresponding powers of governments in many other industrial countries. While there could be several reasons for such sweeping differences, one had been built into the Constitution. Whereas most countries required their firms to have a charter from the central government, and such charters typically required that the powers granted through such a charter be used broadly for the public benefit in what is called "stakeholder capitalism," the United States was virtually unique in not locating authority for chartering at the federal level, but rather at the level of state government. The states, now numbering fifty, have oftentimes competed to attract investment by weakening their corporate regulatory and tax environments and firms have been responsive to such lures. As a result, US firms have no mandated mission to contribute to society, only to obey the laws and regulations of the state and federal governments.

Thus, the US legal system has been used to greatly enhance the power of firms as well as to regulate them, and the governance issue was to understand the balance between that empowerment and regulation. Harvard Law School Professors Duncan Kennedy and Morton Horwitz have explained the development of certain key legal concepts, and how they played a distinctive and very powerful role in promoting the empowerment of firms, a set of circumstances that was largely unfamiliar to me as

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[6] Charles Perrow, *Organizing America: Wealth, Power, and the Origins of Corporate Capitalism* (Princeton, NJ: Princeton University Press, 2002).

we began the research for Chap. 13. Much of the literature was ignoring the constitutive role of the state in the empowerment of firms on the one hand, and its more or less adequate role as a regulator on the other. All of this seems obvious to me now; but at the time it was anything but. The prevailing legal theory of the period from 1870 until 1937 was developed in an era when Republicans controlled the White House 75% of the time (between 1860 and 1932), and, as a result, the Supreme Court during that era had an almost continuously conservative tilt, which reshaped US law and indeed US economic development. Furthermore, competition in "regulatory laxity" among the states rendered charters of incorporation virtually legal formalities; states conferred rights with minimal corresponding responsibilities.

These crucial formative circumstances were radically different from those in most if not all other industrial democracies. Indeed, the laxity of standards of incorporation in the United States continues to distinguish the United States from much of the rest of the world. Thus, in looking at the 19th century, the active competition for economic and political power—as well as the forces that shaped that competition and the impact it exerted on institutions—emerges as continually relevant. The shift in power away from the states and toward firms seems more important to me than the shift in incomes among individuals toward the more affluent. However, a rebalancing of this power relationship between the firms and their erstwhile regulators was only achieved through a constitutional confrontation between the President and the Supreme Court, in 1937. The de facto resolution of this conflict gave the United States a capitalist system with a policy tilt much more similar to those in other industrial countries, a situation that would last until about 1980, when the United States would once again move toward its uniquely business-oriented laissez-faire model.

This 19th century history became clear to me as I prepared to give a seminar in Ottawa, Canada, in June of 2008, to the Harvard Business School Alumni of that region. The occasion was a program organized by Alain Martin for their club members and guests. When Alain asked if I would come give a talk to his members on US capitalism, I set as my two conditions that it be an all-day meeting and that it conclude with a Canadian panel that would comment on the differences and similarities between US and Canadian capitalism. I was surprised that Alain accepted to even try, and even more that he succeeded in finding about 70 participants.

As the meeting approached, I was charged with learning to teach what is now Chap. 13, recently completed with the expert assistance of Research Associate Linnea Meyer. As part of that preparation, I asked Linnea to look into the 1937 confrontation between Franklin Roosevelt and the Supreme Court. Linnea returned with a book by Robert Jackson, who had served as a Supreme Court Justice and, eventually, the chief war crimes prosecutor at Nuremberg.[7] As it turned out, Jackson was FDR's Solicitor General during that confrontation, and his book gave a powerful account of what was at stake for US democracy as well as capitalism in this confrontation. Drawing on Oliver Wendell Holmes, Jr., Jackson laid out his

[7] Robert H. Jackson, *The Struggle for Judicial Supremacy: A Study of the Crisis in American Politics* (New York: Alfred A. Knopf, 1941).

vision of the role of a Constitution in considering the various forms of capitalism: the Constitution should not legislate a form of capitalism but should instead provide a framework in which such choices could be made by Congress, which would roughly parallel European constitutional practices. However, the confrontation between Roosevelt and the Supreme Court was not settled on the basis of principle but rather resolved by a tactical accommodation. As Jackson notes, that basic constitutional issue remains unresolved; today, it is again a source of tension, as Jackson warned that it might be.

In response to my lecture on that history, the Canadians at the HBS meeting explained that their democracy worked quite differently from the American model. The Canadian Constitution, promulgated in 1867, had been inspired by front row seats for the recently concluded US Civil War, rather than the American Revolution against the tyrannies of King George and his ministers. As a result, the Canadian Constitution spoke far more of government's obligations than of citizen rights, i.e., peace, order, and good government, without mention of life, liberty, and the pursuit of happiness. Canada had not deregulated its financial sector in the 1980s, and consequently had curbed any outbreak of irresponsible borrowing or lending before it started, thus sparing its economy exposure to anything like the financial leverage the US had allowed. The Canadians on the panel included Raymond Chrétien, former Canadian Ambassador to the United States (1994–2000); Barbara Stymiest, Chief Operating Officer of the Royal Bank of Canada; Gaëtan Lussier, Chairman of the Canadian Agri-Food Policy Institute; and Joseph Martin, Director of Canadian Business History at the University of Toronto's business school. Charles Morris, an American "guest" and the author of *The Trillion Dollar Meltdown*, joined the panel as a bearer of news on the US capitalist system.[8] It was a great opportunity for the Canadians to appreciate the value of the visible hand of their government in the form of effective regulation, while wondering out loud how it was that Americans could tolerate such an "obviously corrupt" system. It was a question that begged for an answer and perhaps even a sequel meeting in Ottawa.

Capitalism Today

Chapter 14, which examines changes in US capitalism and democracy since 1965, turned out to be the most difficult to research and write, as the recent history described in the chapter has not yet been explored and explained by many scholars. I was disappointed, for example, not to find a satisfying explanation of the Reagan administration's strategy of deregulation, though much has been written on the fiscal policies of Reaganomics.

Deregulation in the United States did not begin as an economic policy, nor did it originate with Reagan. As I inquired, it became clear that deregulation started in the area of social policies, as early as the 1960s. Social deregulation had a very different

[8] Charles R. Morris, *The Trillion Dollar Meltdown* (New York: Public Affairs, 2008).

logic from economic, and the most powerful effects of both were felt in the political system; these circumstances were identified and analyzed by Fareed Zakaria in *The Future of Freedom*.[9] Further, starting in the mid-1970s, the deregulation of the political system had the unintentional effect of ceding political power to the private sector, in a set of circumstances that have been of fundamental importance both to the governance of the United States and indeed to the world. Yet these changes have not been widely appreciated, and most especially not in the United States itself. Rather, starting in 1981, it became fair to speak of a revival of business oligarchy in a pattern not repeated in many, if any, other industrial democracies. Why did it happen in the US for a second time, when the federal government was undoubtedly the most powerful political authority in the world?

In my analysis, this third transformation of US capitalism[10] was driven in part by broad societal forces, which I explain at some length at the beginning of Chap. 14 because of their extraordinary importance to capitalism the world over. At the same time, part of the transformation of US capitalism came from a change in the managerial models of US firms, most notably from stakeholder capitalism to shareholder capitalism, or more realistically to capitalism for the elites in charge of the firms. This change in governance was assisted by the addition of extraordinary levels of incentive compensation for top managers. Here, by serendipity, my years researching and writing about the management of firms, in Europe as well as the United States, came in handy. US firms were embracing a shareholder-oriented version of capitalism which, with the self-assured guidance of Milton Friedman and Michael Jensen and others, argued that the firm had no responsibilities to society in return for the powers conferred by its charter, other than those obligations explicitly spelled out in the laws and regulations, which they knew (or should have known) to be very imperfect and thus riddled with negative externalities. Furthermore, deregulation was reducing societal responsibilities while the continuing growth of lobbying and political corruption was opening the prospects for the private sector to capture more and more of the rights to govern the system in preference to elected officials. It was sure to increase the inequalities of power as well as incomes, which was rapidly evident.

In analyzing the oligarchic takeover of US governance, it was important to recognize that, in both the 19th and 20th century cases, US democracy had been transformed alongside US capitalism. The addition of Chaps. 3 and 4 provided foundational chapters on US democracy, creating a conceptual base for an analysis of US democracy in parallel to Chap. 2, which introduced theories of capitalism. But the emergence of shareholder capitalism made the US situation radically different from most other countries, a situation that I could not explore in depth.

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[9] Fareed Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad* (New York: W.W. Norton, 2004).

[10] As explained in the concluding chapter, I have classified US capitalism as having experienced four phases, and hence three transformations.

In 2009, thanks to a suggestion from Springer editor Niels Thomas, we changed the title of the book once again, to its current incarnation, to reflect the fact that capitalism was an evolving or emergent system, and not one that was either natural or fixed. It was an evolving system with the need to continually rebalance the relative powers of the public sector and private. Capitalist evolution was, in part, the outcome of political competition within a country, where the regulatory processes could be reduced or even subverted in this competition. Uniquely, in the US case, the laws could also be changed by the Supreme Court, as sovereignty was divided among the three branches, a point that was once again apparent when the Court overturned previous precedents to clear the way for virtually unlimited political spending by corporations and unions as part of their newly recognized rights to free speech under the Supreme Court's interpretation of Article One of the Constitution.

But there were other evolutionary issues in the historical materials as well. Europeans established permanent settlements in South America about a century before doing so in the area that would become the United States. All the same, my reading of the available sources strongly suggests that capitalism came to North America about 200 years before it was adopted anywhere in South America, a possibility which seems little recognized. I suggest that the United States and Canada passed Latin America because of this head start with capitalism. Here again, political issues delayed the establishment of Latin American factor markets by centuries. Getting that history straight may help focus attention on the role of *capitalism* relative to *capital* in the development process, as I argue in Chaps. 6 and 7. This line of analysis would suggest that the European approach to spreading their community through adoption of thousands of pages of regulations to be superior to the promotion of development largely on the basis of free trade. Free trade does not spur development unless a country or region has something of value to trade, and agricultural commodities tend to be toward the bottom of the value chain, as Erik Reinert has explained in his book *How Rich Countries Got Rich and Why Poor Countries Stay Poor.*[11] Further, free trade only induces much development in countries with the political capacities to reform their institutions for their own advantage.

Chapter 5, on the Origins of Capitalism, was written mostly in 2000 and 2001, or almost at the start of my examination of governance. In retrospect the definition of capitalism was the key conceptual contribution from which others flowed because it permitted a much more accurate identification of its origins as well as some of the key steps in its evolution, but this significance only became apparent to me gradually as the work progressed, and especially through the case examples in Chaps. 6 and 7. Had I recognized it sooner, I might have chosen to write Chap. 5 with more historical detail. For example, with an explicit definition of capitalism as a system of governance it was clear that Venice was the historical leader thanks to its limited

[11] Erik S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (London: Constable, 2007).

monarchy (dukedom), and thus a stable yet evolving system of governance for at least 1,000 years prior to the arrival of Napoleon's armies, and the text could easily be adjusted to incorporate this insight. Furthermore, it was clear that most of Europe did not have capitalism by 1800 or even 1820. France became capitalist at some point after the overthrow of feudalism in 1789, but not before several attempts to establish limited monarchy in the 19th century. Similar transformations came even later in Austria, Italy, Prussia, and Spain. In addition, I was surprised to discover that the US would establish capitalism along its East Coast early in the 17th century, centuries ahead of some of the major European States. Adopting capitalism centuries ahead of most of the world seems to have been a clear American advantage, even if it was an atomistic form of capitalism which would become anachronistic in the context of its industrial giants from the 1840s onward.

A more troubling issue to be dealt with was the financial crisis that became visible in August of 2007, when first the European Central Bank and then the Federal Reserve had to make huge injections of cash into the financial markets before they opened on a Monday morning. I sought advice on this, including from author Charles Morris (*The Trillion Dollar Meltdown*[12]) and investor/philanthropist George Soros. Following the Lehman Brothers bankruptcy, these inside observers were in agreement that lax regulation was not the platform for freedom for the market participants so much as a platform for irresponsible behavior by the private sector and ultimately for chaos. Financial markets were not self-regulating any more than competition between hockey teams which could use their sticks as clubs. What was needed was a better understanding of how capitalism worked, and how and why so many otherwise wise people, such as Alan Greenspan, could believe that financial markets were both efficient and essentially self-regulating. This books aims to explain how it works and why it cannot be self-regulating. It will not try to explain why those basic realities are not apparent to some very smart people. I put this material in an epilogue to reflect the obvious notion that this only reflects something close to instant history describing a story that will be researched for decades to come, and obviously much better understood in that process.

Finally, I tried to draw some conclusions. In that process, I return to my central theme, the role of US capitalism and democracy in the US and still more in the world. Here I draw on the concepts and evidence in the book to evaluate a contemporary Capitalist Manifesto which I find very superficial and therefore not reassuring at all. Some of our leading political scientists have been right when they recognize capitalism as a system of governance, and they follow this by saying that it is such a complicated system that they cannot say much more. Unfortunately many economists still seem to have failed to recognize it as a system of governance, which leaves them trying to explain how legislatures set policies and institutions in terms of quasi-automatic cost-benefit analyses or through some form of subversive capture of the political authorities. The notion that this process of capture depends on the distribution of wealth generated by a particular variant of capitalism does not get the

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[12]Morris, *The Trillion Dollar Meltdown*.

recognition it deserves. A grossly unequal distribution of income and wealth has the potential to subvert the democratic political process anywhere anytime. The systems of capitalism and democracy act to transform each other, as Gabriel Almond has so ably pointed out.

There is much to be learned in this field of political economy, and hopefully ways will be found to break down the artificial barriers that have imposed limits on various disciplines. I intend this book as a step in that direction, one of historically based multidisciplinary research that eschews grandiose modeling that runs far beyond any empirical base. Perhaps there is something to be learned about academic scholarship from this experience. An outstanding liberal arts education can still be a valuable starting point for comparative research in the historical development of governance systems.

Cambridge, Massachusetts

Bruce R. Scott

Acknowledgements

This book was almost 20 years in the making. While my name appears as sole author, and while I bear final responsibility for the text before you, I could not have pursued let alone completed this book without the encouragement as well as research and writing help of a number of other people.

The five contributors I name first were substantively and intellectually integral to the publication of this volume. The youngest contributors of the five were three Harvard Business School research associates, each of whom I came to think of as a junior faculty colleague. Jamie Matthews, Wellesley College '99, worked with me for 4 years. She co-authored two cases on Italy, examining its development as a country hosting two separate systems of governance in its northern and southern regions. Those cases are condensed here as Chap. 8, which focuses on the role of patron–client relationships and corruption in governance in Italy's Mezzogiorno. Jamie also drafted a companion case on the United States, examining the role of segregation in the South from 1870 until 1970; this work comprises Chap. 9. Jamie's research on the origins of capitalism also contributed substantially to Chap. 5.

Sarah Potvin, Harvard College '04, drafted a case on the United States 1630–1830, describing the particularly benign, atomistic set of circumstances in which early US capitalism was nurtured; that case is adapted here as Chap. 7. In addition, Sarah suggested adding democracy to the scope of the book and, on her third try, persuaded me. She went on to co-author Chap. 3, which examines capitalism and democracy.

Linnea Meyer, Harvard '07, undertook the task of developing Chap. 13 on capitalist governance as the balance between using the regulatory powers of government for the empowerment of firms on the one hand and their restraint through regulation on the other. Following an initial period of almost 200 years, 1630–1830, when US capitalism can genuinely be described as atomistic, when even the largest US firms had exceedingly little economic power, in the next 100 years the largest firms grew to be some of the greatest concentrations of private economic power the world had yet seen. In this period, 1830–1937, the rise of large-scale industry empowered the largest US firms to challenge governments, both state and federal, in their attempts to regulate the use of power by private actors. While technological changes and market growth played essential roles in this process of private empowerment, as indicated by the fact that the largest firms grew more than a thousand-fold just in terms of employment, the legal system was also used to permit new forms of organization and a reduction of the responsibilities of firms as conditions for receipt of those grants of power. As a result, this chapter was an unusual challenge, both technically and in political terms; it required a substantial foray into US legal and regulatory history including constitutional history.

In addition Linnea edited Chap. 2, to clarify the explanation of the key concepts in the book. As that chapter emphasizes, capitalism is a system of governance, with the power and the legitimacy to go far beyond the coordination of supply and demand based on the price mechanism; that is, it can modify institutions, including property rights and the roles and responsibilities of various actors, political as well as economic, in a system that is political as well as economic. Chapter 2 underlines some of the costs of academic specialization, and particularly of quantitative research in areas where premature quantification can obscure reality as much as it sometimes illuminates that reality.

In addition to their specific contributions, these three recent graduates used their liberal arts training to develop multidisciplinary cases on economic development, each of which contributed to the development of the theory of capitalism in the book. They are exemplars of what can be achieved through interdisciplinary research.

John Rosenblum, a former Harvard Business School faculty colleague, long-time friend, and former Dean of the Darden Business School of the University of Virginia, served as an advisor on this project almost from the start. He read and commented on many of the chapters and, most significantly, played a key role in guiding the book to completion over the past 2 years. In particular, in the spring of 2009 John made the crucial suggestion that we publish Chap. 2 separately to help establish the key theoretical concepts in the book. It was a wonderful idea, and it was accepted by Springer. That chapter, the same one that I had sent originally as a sample to Springer back in the spring of 2006, and on which they decided to become the publisher, was expanded slightly as a slim monograph, with the help of Linnea's careful editing, and it was published in the summer of 2009 as *The Concept of Capitalism*.

I was also very fortunate to have Niels Thomas of Springer join the project as my editor. With his PhD in economic history, Niels was uniquely qualified to broaden my vision of the manuscript. Specifically, he asked if I could bring the US material up to the present rather than ending in 1830 as I had planned, in order to show readers how and why US capitalism was so distinctive compared to the well-known European varieties. My agreeing to his suggestion added four chapters, hundreds of pages, and 3 years to the project. It has been a happy collaboration as our mutual understanding of capitalism evolved. Without my realizing it, that decision changed the book to one that looked at the evolution of capitalism and not just its origins or how it worked at any particular point in time.

In any event, the principal members of the cast were three "seniors" and three "juniors." They included a former faculty member and dean serving on the board of a large private money management firm based in Boston; our editor at Springer in Heidelberg, whose training was steeped in the importance of the role of institutions in development; three recent college graduates with liberal arts degrees, all of whom had studied a considerable amount of history, and who, together, worked on the book a total of almost 9 years; and, finally, myself, a senior faculty member in Cambridge, MA, who trained as an MBA-DBA, initially wrote field-based cases centered on the management issues of firms in the United States, France, Sweden, and Switzerland, and went on to focus on cases and articles on country strategies.

Beyond this core group of six, I had the help of a number of people who were mostly long-time friends on the Harvard Business School faculty, but included some outside teachers. The faculty colleagues came from two particular areas: General Management, which is the study of firms as behaving systems and was built around the two ideas of *strategy* and *governance* of firms, and Business Government and the International Economy (BGIE), an interdisciplinary course which took countries as behaving units and looked at them from the viewpoints of their governments, and particularly their economic strategies and, much less systematically, their systems of governance. Norman Berg and Malcolm Salter were colleagues from my former area, General Management, beginning in the early 1960s. Norm reminded me of the importance of giving Milton Friedman his due, with his concept of capitalism as a self-regulating system, being sure to allow him to explain it in his own words before I proceeded to vigorously disagree with him, in Chap. 2. Mal called my attention to the fact that BGIE had been built upon the concept of national strategies without nearly as strong an intellectual counterpart in terms of governance, a counterpart that only came with the notion of capitalism; this observation was pivotal to the eventual text, and I wish I had been able to see it many years earlier. John Rosenblum had taught in both of these required courses, and we each switched to teach a required course which became BGIE in 1973, where he was a founding partner in an effort to apply the general management model to the study of countries. It was a partnership where I took the lead on the case writing and John took the lead in figuring out how to teach historical cases on countries from the point of view of general managers, meaning senior government officials such as ministers of finance.

The book project also benefited substantially from a little teaching group that sprouted spontaneously in the winter of 2009, when Tom Piper, a senior colleague in the Finance Area, Linnea, and I began meeting regularly to discuss the cases before I taught them. It was one of the real pleasures of my being involved with teaching, and it enlivened my final semester as an active member of the faculty.

Colleagues from the BGIE group begin with George Lodge, who was there at the founding in 1973. We worked together on the faculty for almost 30 years; George shared case writing responsibilities while approaching our mostly common subject matter from the point of view of ideology rather than either strategy or governance. We both learned from this long, collaborative experience. David Moss was a strong supporter when I began this research effort, and, as a result, he was repeatedly asked to comment upon revisions of revisions. I am most grateful for his advocacy on behalf of focusing and clarifying the introductions to Chaps. 13 and 14. These two chapters were the longest and the most difficult to write. Rawi Abdelal gave me a major assist in interpreting the political science literature, and especially in confirming the utility of Abraham Lincoln's distinction between government *by* the people from government *for* the people, which was crucial to understanding effective governance.

A number of other faculty played more specialized roles. Bill Fruhan, an expert in corporate finance, helped me with a number of issues in Chap. 14. Jonathan West, an Australian and a specialist in management of technologies, reminded me on numerous occasions that the book was not about globalization, but about countries and their governance. Ian Marsh, an Australian professor of political science, explained how political markets differed from their economic counterparts. Tom Mondschean, of the Economics Department at DePaul University, co-authored a case on the competitive challenges facing the US economy circa 2000 and supplied us with some of the background figures for Chap. 14.

I also had some teachers based outside of the academy. First among them I would like to acknowledge Michel Vermersch and Pierre Gadonneix, both friends since the late 1960s, students of public affairs in France, and eventually CEOs of major French firms. Michel headed Guyomarc'h, SA, a major agribusiness firm based in Brittany, while Pierre, a former doctoral student in the General Management area, became a lifetime civil servant, serving in the Ministry of Industry, at Gaz de France, and, finally, as President Director General of Electricité de France. Both Michel and Pierre were distinguished teachers in my mind because neither ever lost respect for the employees who worked with them, including those who had never had their advantages of studying at France's elite schools. In addition, neither needed stock options to motivate their outstanding performance; they believed their responsibility was to their colleagues and fellow employees as well as their shareholders.

Second, I would like to acknowledge the friendship and example of Robert S. K. Tucker, a South African lawyer and banker, who invited me to join a scenario team to look at the future of his country in the post-apartheid years, and who was subsequently chosen to help lead in the development of a set of regulatory standards for affirmative action in the financial services sector. It was Bob's gift to be able to see where the public interest lay, as well as the interests of the more obviously involved parties, and he had the courage to stick up for that public interest even when there was pressure not to.

Third, two South American graduates of the HBS Owner President Manager Program extended the reach of my education to South America. I have enjoyed extended on-site visits to Brazil and many discussions with Luis Paschoal, a resident of Campinas, a cultivator of prize-winning coffee, and a tireless advocate for the education of employees and others of modest means and for the role of volunteers in promoting community initiatives, including for better law enforcement in Campinas. Bernardo Dominguez, a real estate developer from Mexico City, took my wife Grenelle and me on a field trip to the state of Michoacán to see some of the modern initiatives built among some of its respectfully protected pre-Columbian towns, while pointing out the exceedingly limited opportunities available to the inhabitants due to their minimal schooling. At that time, it was, as he and the Governor agreed during our meeting one afternoon, the only state in Mexico where poor education was a more serious problem than the lack of security.

Fourth, I would like to acknowledge three former officers in the US Army—Colonel Gregory Fontenot, MG William Nash, and BG James (Volney) Warner—all of whom were actors in the support operations for the Arizona Market in Bosnia in 1996/1997. These officers demonstrated a capacity to recognize the implied mission of US forces under their command as well as their formal mission, and each had the courage to "do the right thing" even when it was not popular to recognize such responsibilities. In addition, Jim Warner came to class on half a dozen occasions, spread over as many years, to teach the material on patron–client relationships in Italy and Bosnia; a natural teacher, Jim led the discussions from the point of view of one familiar with the use of coercive force for purposes of persuasion.

Fifth, I would like to acknowledge the examples of two remarkable teachers from the public sector of Singapore, Philip Yeo and Tharman Shanmugarantnam. Philip was a student in the MBA program who went on to preside over the Economic Development Board of Singapore for almost 20 years with a rare combination of vision and energy. Philip was also early to be concerned about the American model of capitalism, a concern that has subsequently become a commonplace outside the United States, Tharman, a cross-registrant in my MBA course from the Kennedy School of Government, has served in the Singapore government as head of the Monetary Authority, and most recently as Minister of Finance. Visiting him in Singapore some years ago he explained how the Monetary Authority could help to finance venture capital if that were needed, even if it was not a traditional activity of central banks, which exemplifies the can-do esprit of government in Singapore.

In addition to their individual accomplishments, I believe that it is fair to say that each of these leader/teachers recognized that the mandate for a firm came first and foremost from society rather than from a transient group of shareholders or other corporate officers. As a result, the top officers should expect to serve with honor as the leader of a firm, without the need for supplementary incentives, much like the Army officers.

Over the course of this project, I have employed a Research Associate almost every year, which would have been impossible without the very generous financial backing of the Division of Research of Harvard Business School. Two Directors of Research played important roles as mentors early in my years on the faculty. Bertrand Fox had oversight of a project on French Industrial Planning, which I worked on for 5 years in the 1960s, and he was an intellectual supporter of the work on country strategies and governance. At the end of the fieldwork there, Bert came to France for a week to directly interview about a dozen of our sources, and thus to accept implicit responsibility for the field-based conclusions. Lawrence Fouraker, another Director of Research, backed the project in France and then, as Dean, backed my experiment in teaching about country strategies from my first attempts in 1971. Subsequently, Dean Fouraker was a backer in my continuing efforts to use the notion of strategy as a way to study and teach about the development of countries, important background for this book.

Hugo Uyterhoeven gave me the original green light to start teaching about country strategies at the end of a 30-session required Business Policy course, provided I gave advance notice to the MBA students who elected the sections. Those early sessions gave me a chance to try out the relevance of the business strategy model in a national context in countries as different as Canada, France, Japan, Mexico, and the United States among others, with very bright students and very encouraging results. Thierry Porté was one of my earliest Research Associates in country-based case writing in France and Japan, and a continuing advisor through his 25 years of service at Morgan Stanley in Japan and then as CEO at the Shinsei Bank, also in Tokyo.

Audrey Sproat was my longest-serving Research Associate, working with me for almost 20 years. She played a leading role in developing the first of the country-based cases for BGIE, and notably for the case series on France and Japan. I was also fortunate to have the help of research associates Ramdas Sunder and Tripti Thapa; while their work is not directly represented in this book, it nevertheless contributed to the learning process that produced it. Edward Murphy was the researcher for the case on The Arizona Market. Linda Kellv-Hayes managed all the affairs at the office, which I appreciated even more the minute that I retired. And Jeff Strabone, a remarkable professional editor, helped polish some of my ideas as well as my prose.

Despite all of my good luck with support, both financial and human, one thought has recurred repeatedly over the last couple of years of this project: This whole process took place without an opportunity for me to discuss the final product with two of my earliest teachers, my parents, Andrew C. and Marion Rockey Scott. Now that I am old enough to appreciate the wisdom of their views, I wish that I could have had the opportunity to discuss Chap. 13 with them to see how they would have reacted to this version of events. I would especially have appreciated having their views on Theodore Roosevelt's support for the notion that the United States needed a much more powerful regulatory system to control its capitalists, starting with a federal charter or license of incorporation. Probably, the ultimate test of their views would have been how they felt about Justice Holmes's dissent in *Lochner v. New York*, where he stated a position to the effect that the Constitution was not intended to take sides between competing visions of capitalism (e.g., laissez-faire versus a more social democratic form of capitalism), but instead to establish a legal framework in which those with differing views could compete for power.

I believe that my urge to understand the origins and evolution of capitalism turned out to be much like that which affects a scientist looking for the causes of events in any scientific domain. I was a researcher first and a teacher second throughout my 40-some years on the faculty of Harvard Business School. As the years passed, the scope and purpose of the research underwent profound changes, and I became acutely aware that I was running a race with retirement. Hoping to finish before that day arrived, other things had to give way, starting with vacations and even family occasions. In the end I postponed retirement until age 76 and still lost the race by 6 months. Thanks again to the help of Linnea and Sarah, I was able to finish in a more or less orderly fashion, with final writing and editing completed in mid-December 2009.

At the same time, the research required me to prolong active duty for 10 years beyond normal retirement, and left me preoccupied during the years that my three

children were marrying and raising small children. They incurred some costs that included a sometimes preoccupied father and fewer "house calls" than they might reasonably have expected. I hope that in years to come the nature of some of the discoveries reported in this book will make my absences of mind as well as location seem less egregious to them, and perhaps to their children as well.

Finally, and perhaps most obviously, this mix of activities could not have worked for such a long period so smoothly, or even at all, without the unfailing encouragement and support of my wife, Grenelle. From 1980 onward, she managed our responsibilities with six children from two households, while editing chapter manuscripts and PowerPoint slides as occasions required, managing all of the bills, and handling most of the chores for two homes as well. Little did she suspect what she was getting into when she came out to Lincoln to cross-country ski in the aftermath of the blizzard of 1978. It turned out to be a commitment not only for richer or poorer, in sickness and health, but for "lunches" as well. There were many occasions when I had doubts about ever achieving anything that might merit publication right up until 2006, and I voiced these doubts to her on numerous occasions, but I could always count upon her as my loyal source of encouragement, 24/7. It is for all these reasons, and the love that they imply, that I dedicate this book to Grenelle.

Cambridge, MA Bruce R. Scott
December 18, 2009

Part I
The Theory of Capitalism

Prologue
Chestertown, Maryland, as an "English" Village

> . . . European villages, towns, and cities usually have more vibrant and successful downtowns than their American counterparts. The ability to shop locally is one of the main reasons for that, and generally speaking local shopping seems to be a lot more prevalent and a lot more pleasurable in Europe than in America. Much of this depends on where you shop (in a town center, in a big-box store or mall out of town, on the Internet); from whom you buy (a sole proprietor or family, a workers' collective, or a regional, national, or global corporation); and what you purchase (locally grown food, for example, clothes made with American cotton, or toys from Japan).
>
> There are indeed big out-of-town supermarkets and big-box stores, especially Tesco, the British analog of Wal-Mart, and a few shopping malls, but they are rarer and smaller. And while many English people do feel that their downtowns have suffered greatly from out-of-town stores, local shopping in England remains substantially stronger than in the US.[1]

These observations are not my own, but instead those of Mark Vanhoenacker, writing for *Sanctuary Magazine*, a periodical published by the Massachusetts Audubon Society. But my own observations, as I have traveled throughout England, France, and Switzerland, have been similar. From these travels alone I can confirm that the contrast brought out by Vanhoenacker's story is more nuanced, complex, and compelling than it might seem at first. So let us continue with his story

> In England, all this results from a mix of necessity and conscious political choice. In a densely populated country such as England (though only slightly more so than Massachusetts), citizens and politicians have put in place a series of laws that, while not perfect, have kept the English countryside remarkably green—one of the country's biggest tourist attractions, in fact—and have also kept downtowns remarkably vital. The most important tool for defending local shopping, in a country where there are still plenty of vibrant downtowns, is simply to stop construction of out-of-town supermarkets, big-box

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[1] Mark Vanhoenacker, "The Nation of Shopkeepers: Old England Could Teach New England a Few Things," *Sanctuary*, Spring 2008, 4. Reprinted by permission of the author.

> stores, and malls, and to make sure that residential and office construction are very carefully planned and located. The planning system, as it's known, is orders of magnitude more complex, time-consuming, and expensive than almost anything you will find in the US. It is explicitly designed to protect both open space and a way of life.
>
> From an American perspective, two major elements of the English planning system are worth particular consideration. The first is the network of greenbelts, rings of protected open land that surround many cities and towns. Greenbelts were introduced before World War II around London, and in the 1950s for the rest of the country. They cover an astonishing 13 percent of England, and once land is designated as greenbelt, whether it is agricultural or wilderness or a mix of the two, it is permanently protected from development. Within the greenbelt, new buildings or developments are almost impossible to construct. Individual citizens can also petition to designate new areas of greenbelt, or 'green wedges,' small islands of nature in built-up areas. By sharply limiting the construction of out-of-town shopping centers and housing developments, the greenbelt ensures a high population density in towns to support local shops, and keeps out-of-town options to a minimum. This, more than anything, has preserved both the English countryside and a way of life that supports local shopping.
>
> The second element to consider is the extraordinarily difficult permission process for developers of stores, houses, or businesses even when land is not protected as greenbelt. Every few years the national government sets out guidelines and rules on town-center development, housing construction, industrial sites, and environmental protection. These rules have always favored town centers to a degree unimaginable in the US; since the mid-1990s they have explicitly advanced the goals of the local shopping movement . . .[2]

As Vanhoenacker relates, the British have gone so far as to arrange their rules, or local incentive structures, to favor small, locally controlled businesses over large chain stores, a very conscious form of protectionism. The national government may, for instance, lower tax rates for small businesses and for those "deemed important to the life of a town or village," or it may restrict the opening hours of stores exceeding a certain size.[3] And, according to Vanhoenacker, the national government's initiatives have largely worked in the sense that "between the mid-1990s and 2005, the percentage of new developments being put in town centers has nearly doubled."[4]

What to make of all this? Vanhoenacker's readers for this article are, by and large, American. What import can the preservation of local shopping in English villages bear on their own lives? Near the end of his story, Vanhoenacker, observing that "perhaps the biggest lesson from the status of local shopping in England is how important government action is to preserving the conditions that make local shopping more possible and more pleasurable," and recognizing that "such steps also happen to advance important environmental goals like protecting open space, reducing carbon emissions, supporting local farmers, and building a sense of connection to the land," recommends that New Englanders pursue a similar route. Voters and initiatives crafted government policies in England, and New England,

[2] Ibid., 4–5.

[3] Ibid., 6.

[4] Ibid., 5.

too, could take action toward "rebuilding our communities and preserving our landscape."[5]

The lesson of Vanhoenacker's story, and of the story of countless other European villages, is one of governance. In the United Kingdom, zoning issues are settled by a centralized governance system; London can over-rule local initiatives in order to protect local social capital, such as the anti-commercial, pro-local, and ultimately personal feel of small-town living. British success, at least in this instance, appears to depend in large part upon entrusting civil servants to have societal interests at heart, and it seems to work. The story is much the same in France.

Could this work in America, as Vanhoenacker seems to suggest? It would, first and foremost, require Americans to overcome their deeply ingrained mistrust of centralized authority, a mistrust institutionalized by the Constitution, with its tendency to allocate power to the states rather than the federal government. Americans would fear, perhaps rightly, that granting such considerable power over zoning—over where, when, and how a store might set up its operations—would allow government employees to favor certain firms over others, perhaps enriching themselves at public expense. We expect less from our government officials than citizens in some of the European countries do, and our expectations are sometimes fulfilled.

And yet, there are examples of American communities that have managed to achieve what Vanhoenacker describes in England. One such example is that of Chestertown, Maryland, a small community in a relatively isolated part of Maryland across the Chesapeake Bay from Baltimore; its elected leaders staged a battle with Wal-Mart to limit the impact of this large retailer on their town. In some important respects it is a surprising story, at least thus far. It is almost as though Chestertown is a bit of the old country located in the New World. Again, I draw upon the words of another author, in this case, John Lang, writing for *Preservation Magazine* in 2003

> In the Chestertown of today, preservation-minded residents fought fiercely for more than a decade to prevent the world's largest retailer from opening a store bigger than their entire downtown. Fending off Wal-Mart took on the emotions associated with foiling the British centuries before—even though the proposed store was to be a mile from the historic district and just outside town limits. The marathon battle made enemies of neighbors, damaged political reputations, and exposed gaps between rich and poor, old and young, black and white, new comers and long-time families. The arguments were about many things—jobs, traffic, cheap goods, local businesses—but the case against Wal-Mart was in the end about a community's right to preserve what it saw as its essential character.
>
> Chestertown has only 4,644 residents, three stoplights on the main route through town, and a total transit time of about five minutes. It would be easy for the casual visitor to miss the colonial homes lining the banks of the Chester River, because the narrow bridge leading into town demands a driver's full concentration. Older by almost a century than the nation itself, Chestertown is still a community of pre-industrial pace. The busiest day typically is Saturday, when people gather at the farmers' market in the village park to buy fresh flowers and homemade cookies and give away gossip. Among the town's odder charms, the

[5] Ibid., 5–6.

> postal clerk sings at his counter and the community marching band features middle-aged majorettes.[6]

Chestertown's "essential character" is, in effect, much like what Vanhoenacker describes in rural England. When Chestertown was eventually discovered by the forces of economic progress, i.e., Wal-Mart, it was unclear whether that character was worth preserving at the expense of a more convenient shopping experience, one with lower costs and larger selection. Unlike their British counterparts, the inhabitants of Chestertown had much greater choice in the matter; no national rule existed to unequivocally permit or prevent the store's arrival in town.

As Lang goes on to describe, the reaction of Chestertown residents to the news, in the early 1990s, that a Wal-Mart store was being planned, was one of "much bafflement—and both delight and dismay"

> The sharply split opinion had to do with how Kent county has developed, or *not* developed. Some families have roots 350 years deep and still try to get by as their ancestors did, farming, crabbing, and oystering. One in 10 Kent County residents live below the poverty line, one in five is 65 or older, nearly one in four is black. Scattered around is another minority that has nested here over the past 20 years, relatively wealthy weekenders and retirees from Philadelphia, Baltimore, and Washington, D.C.
>
> And for all, rich and poor, shopping is a challenge. The more sophisticated know to look in one of Chestertown's two shoe stores for *The New York Times*, and they go to a particular gas station for the freshest vegetables. For bigger-ticket items, many drive 45 minutes to Dover, Del., where there are strip malls, including a Wal-Mart, and no sales tax.[7]

In Lang's framing, "The main issue was social preservation—seeking to save the cultural institution of a small town's shopping area."[8]

The residents of Chestertown were not the only ones arguing; Wal-Mart also had a voice, one drawing less upon the values and conveniences (or lack thereof) of local town life and more upon the law itself. As Lang's description reveals, the law governing such zoning issues in Chestertown were quite unlike those governing the same issues in most English villages; they were locally mandated and, some would say, unclear in their specifics, a far cry from the nationally mandated and quite focused English law. Wal-Mart argued that the county zoning ordinances, which set no size limits on retail outlets, was binding; a coalition from the town, however, disagreed, and pointed to the county's comprehensive plan, dating from 1984, and argued that a Wal-Mart outlet would violate that document's emphasis on growth that complemented existing communities and encouraged local firms.[9]

As Lang goes on to relate, the coalition against Wal-Mart's entry (known as the "Coalition for the Preservation of Chestertown") tried to negotiate with Wal-Mart, proposing that it limit its size to 25,000 square feet. As Wal-Mart put pressure on

6 John Lang, "Chestertown: Battle of the Big Box," *Preservation*, November/December 2003, 26.
7 Ibid., 26–27.
8 Ibid., 28.
9 Ibid., 30.

the local politicians, the coalition upped the limit to 50,000 and then 65,000 square feet. Wal-Mart still refused to restrict its expansionary plans, with one of its representatives asserting to the coalition that it “would make an example of Chestertown, adding, ‘We don’t lose.’”[10] But the coalition ultimately prevailed, preserving the local shopping culture of Chestertown. This culture was one rich in social capital like that Vanhoenacker described in England. As Chestertown’s mayor asserts, it is a culture rarely fought for with success in America today, and less and less found as a consequence. Chesterton, he argued, “‘is a place alive. Farmers still come in from the country and sell their goods as they used to 10 years ago. It brings in people we haven’t seen all week and we catch up with each other. People who live in bigger areas spend Saturdays in cars going from shopping center to shopping center.’”[11]

What the mayor’s observation and Lang’s narrative fail to underscore, however, are two crucial characteristics of Chestertown, in addition to its relative isolation and its long traditions, that set it apart not only in terms of its culture, but also in terms of how it is able to preserve that culture over time. And this is where my own account, and the motivation of this book, begins.

Supporting Chestertown’s special small-town culture were a special set of geographical endowments and a special set of political institutions. First, Chestertown was in Kent County, an area bordered on three sides by water—two rivers and the Chesapeake Bay—and on the fourth by a very lightly populated part of Delaware. Thus, geographically it was a peninsula that had limited connections to the surrounding areas.

Second, and still more importantly, Chestertown was located in Maryland, a state that delegated control of zoning and property development to its counties in a system known as “home rule.” According to home rule, Chestertown’s zoning was under the control of an elected commission that spoke for Kent County, a political district that covered 414 square miles (only 279 of which were land) and was home to 19,000 inhabitants. The relevant zoning district was therefore not just the tiny town of Chestertown, which comprised 2.8 square miles (only 2.6 of which were land) with less than 5,000 inhabitants. This distinction was crucial to enabling the people of Chestertown to control their own destiny in this confrontation. Although it may seem contradictory, county control of zoning allowed the local town of Chestertown a greater say in granting or not granting Wal-Mart’s petition for a zoning permit. To explain: Wal-Mart had asked permission to build just outside Chestertown’s town limits, but within Kent County. It was a strategy Wal-Mart had used time and again to counter local zoning ordinances: they built just across the line and circumvented local government altogether. Zoning was, in this case, an essential component of property rights, as it would be if a landowner wished to build right to the lot line or to open a business in a district zoned as residential.

[10] Ibid., 29.

[11] Quoted in Ibid., 30.

By locating outside the boundary line of the town, Wal-Mart could serve the local market with one of its efficient "big box" stores, whether the local government of Chestertown liked it or not. However, since Kent County's government was in control of zoning for Chestertown, Wal-Mart's strategy failed; Wal-Mart would have to build farther away, across the county line, which was far enough away to leave Chestertown relatively safe from Wal-Mart's commercial influence on its small-town culture.

However, Chestertown's story is not that of most US towns.[12] One of the key features of the US capitalism and democracy is that control of land has been highly decentralized from the outset, as a reaction to excessive control from the British Parliament and King prior to Independence. The remedy then and even now has been radical decentralization, from the period of earliest settlement and institutionalized with the Northwest Ordinance of 1787. In that one piece of legislation, Congress created a single "subdivision" covering five states and 400,000 square miles, all divided neatly into sections of a square mile and further divided into quarter sections. Local government was organized around townships of approximately 36 sections of 1 square mile each. It was a remarkable system in its day, setting aside one section in each 36 to help finance local schools, a system which contributed to the nascent nation's ability to offer widespread public education. This system's approach to zoning has remained a key building block in the US capitalism and democracy even as the nation has fundamentally changed over more than 200 years. One of its legacies is that the United States now has more than 14,000 public school districts, typically with their own taxing as well as spending powers, and perhaps a similar number of zoning districts.

Decentralization has been quite a distinctive aspect of the US governance and has undoubtedly contributed to US public goods such as education, noted above, as well as local police, roads, and sewers. However, circumstances have evolved considerably since the late 18th century, such that the zoning structure created by the Northwest Ordinance, which has remained largely true to its Jeffersonian design, does not quite fit anymore. The Northwest Ordinance was formulated and passed when one's ability to get to market was limited by the durability and speed of a horse and buggy. In addition, it was passed at a time when the United States had no large firms. A century later, firms with 100,000 employees and vast aggregations

[12]There are other towns like Chestertown, including the town of Stanwood, located on Camano Island just outside of Seattle. After much debate, beginning in the fall of 2004, the Stanwood Planning Commission ultimately refused in April 2005 to alter its land-use or zoning plan to permit commercial development on property Wal-Mart intended to buy and develop. The Commission was supported by the majority of residents who voted in April's public hearing on the issue and who opposed Wal-Mart for reasons similar to those of the Chestertown residents, such as preserving the residential feel of the town and supporting its small businesses. Stanwood is also similar to Chestertown in that proponents of commercial development, such as Wal-Mart, would have to gain not only the approval of the city, i.e., the Stanwood Planning Commission, but also the approval of the county, i.e., the Snohomish County Council.

of capital gave these private entities more power than many state governments, let alone counties or villages.

Today Wal-Mart is truly an icon of successful US capitalism. At the same time, with its vast purchasing budget and influence as an employer, Wal-Mart also represents the power of the private sector to potentially abuse the system. Faced with a zoning challenge, Wal-Mart, like other firms even a fraction of its size, can hire a platoon of lawyers and thereby outspend and overwhelm local zoning boards made up of elected officials who typically depend upon outside legal counsel. The latter must ask their electorates to pay for legal counsel in order to defend their interests, a request that potentially pits the short-term interests of a mobile fraction of the population against the long-term interests of other fractions, some with histories dating back 200 or even 300 years. How adequate is it, then, for these towns to retain nominal authority over zoning when, given their small size, they cannot practically exercise it? Potential new arrivals can simply circumvent the rules these towns set by developing their stores just across the town line. Radical decentralization may have been a stroke of genius in 1787, when the local governments were of similar scope as the entrepreneurs who served the town, but today no such balance of power exists. The US capitalism has vested great economic power in its large firms to achieve great results, not least in terms of increased selection and lower prices, but it has done so in a context where the firms' corresponding charters of incorporation do not require them to take into consideration how their actions affect the welfare of the communities that they affect. Since the Civil War, and still more since 1980, this lack of explicit responsibility to the community at large has implicitly oriented the mandate of US firms toward enhancing shareholder wealth. In turn, this focus on enriching a small minority of the population has become a distinctive aspect of American capitalism and is an attribute that I will consider in some detail in this book.

In England, zoning power rests ultimately in the hands of high-level officials in London. These officials are part of an elected government, yet shielded from direct political pressure. The larger size of British (and European) zones and accordingly larger reach of their zoning authorities, in contrast to their correlates in America, are illustrated below in Fig. P.1. If we assume, given the narratives above, that zoning is more effective in protecting the property rights of local communities under the

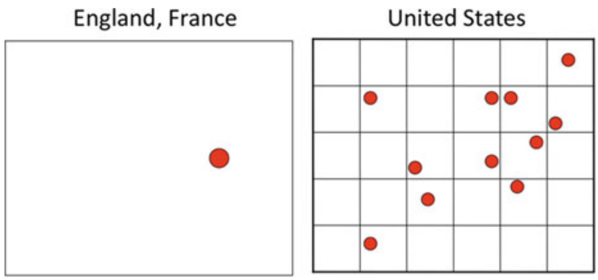

Fig. P.1 Zoning regions in England and France versus the United States. Source: Bruce R. Scott more centralized English system than under the more decentralized American one, then we face a somewhat paradoxical situation: Making things “more democratic” in the allocation of zoning authority does not necessarily lead to policy-making that is more nearly in the interests of the public. Instead, it often means reducing the powers of elected officials in the face of the economic power of organized business, a situation that then allows the interests of the private sector to prevail over those of the public.

Where do these stories fit in the narrative of this book? As I see it, these apparently minor issues of zoning and community development are compelling illustrations of how capitalism and democracy interact in modern societies and, specifically, of how their respective institutions affect one another. Capitalism, like democracy, is a system of governance, and the institutions of capitalism, such as zoning rules for building permits, are ultimately shaped through political processes. The critical features of capitalism are not so much in the operations of markets as they achieve equilibrium, as in the institutions or legal frameworks supporting and shaping those markets to achieve equilibrium. Political forces determine whether that equilibrium favors capital or labor, producers or consumers, and private interests or the public interest. Moreover, political forces help determine changes to that equilibrium over time, through reform that may or may not promote the long-term development of their societies.

Culture and economics can and do shape local markets. But only government can actively and purposefully change market frameworks, which control both national and local markets. Government alone can actively and purposefully change those markets’ frameworks over time. If government power is circumscribed, as in the decentralized zoning protection of most American towns, such change is likely to favor those able to exert the most power at the local level, i.e., large firms. A more centralized system focused on the promotion of social capital, such as that in England, could potentially create a very different balance of power, so long as government officials sought to use that power to protect the public interest as expressed through elections. However, there is no guarantee that such power would be used in the public interest; centralized regulatory powers could well be used to promote the interests of favored firms.

No system of political governance can be expected to serve the public interest unless the relevant public officials make a good faith effort to do so. If US regulators had additional power and were to use it for public purposes, then the nation might revive more commerce in its town centers, and more of its private life might take place in walkable villages where people met each other face to face, instead of passing in their cars as they drove to and from their shopping malls. My point here is not to suggest that quaint villages should be a universal model for American life—they do not play any such role in Britain. Nor is it to suggest that the revival of small communities would help the US compete with China or India. Rather, my point is that, at present, such a choice is not even within reach of most American communities, whether they want it or not, because of the legacy of a local zoning system conceived more than 200 years ago, in an era when markets and firms were similarly local in nature.

The capacity to modernize institutions, political as well as economic, is surely one of the fundamental requisites of a society that aims to focus on the changing needs and desires of its inhabitants and adapt accordingly. An improved understanding of how societies can modernize their capitalist institutions and how essential government is to this process of adaptation is one of the prime objectives of this book.

Life in capitalist democracies is shaped by two systems of governance: democracy and capitalism. These two systems influence each other and can be made to serve the public interest if their potential is understood and adapted accordingly and effectively. If society is to be democratic, this adaptation should be controlled through the political process, by the visible hand of government. This book aims to explore the origins of capitalism and to point out that, as a system of governance, it is built from the visible hand of human agency in the form of political choice, rather than the invisible hand of market forces in the form of supply and demand. Chestertown is one of the relatively rare historic jewels in the American landscape, a country that is far newer and faster growing than England. Chestertown cannot be duplicated artificially or considered to be a national model. However, the zoning power of Kent County could be created in any state that chose to do so; it simply requires the vote of a state legislature in favor of enlarging zoning districts from the town to the county level. Such reform would amount to the utilization of the democratic process to rebalance public power with private.

Chapter 1
Introduction

Capitalism and democracy co-exist as the prevailing systems of governance the world over and they inevitably interact with each other and transform each other.[1] However, with few exceptions they did not emerge simultaneously and their historical relationship is complex and far from obvious. Capitalism generally came first, often by centuries, and its decentralized system of decision-making appears to have been a necessary precondition for the successful establishment of democracy. The rise of capitalism thus becomes of pivotal importance not only as a new and promising form of economic governance, but also as a precondition for the rise of large-scale or representative democracy.

In historical terms, both capitalism and representative democracy are of very recent vintage.[2] Indeed, the dominance of these two systems in their contemporary forms only dates from 1990. In spite of their prevailing roles in their respective spheres of human activity, neither system is easily defined or understood. Though their mutual existence is based upon a continually emerging interdependence, one is compelled to analyze each as a separate entity. Each has typically evolved from simpler systems—capitalism from trade in goods and services that, many centuries later, came to include factor markets for land and labor; and democracy from limited monarchy, which in turn typically emerged from feudalism. But despite their differences in origins and function, both capitalism and democracy were propelled into existence by political transformations and not just economic growth.

Capitalism and democracy are studied separately, and clearly both merit specialized study. But their interdependence suggests the need to consider how they influence each other, though doing so may challenge the usual boundaries of academic specialization. To consider their separate existence as well as their co-evolution requires the reestablishment of some of the earlier perspective of political economy.

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[1] Gabriel Almond, "Capitalism and Democracy," *PS: Political Science and Politics* 24, no. 3 (September 1991): 467–474.

[2] Modern democracy is based upon the elections of representatives. Direct democracy, as practiced in Greek city-states is of course much older, but it did not survive in any direct chain of events, a matter that I discuss in Chap. 3.

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Some Key Conceptual Issues

Coordination and Governance

The genius of capitalism lies in its recognition of the coordinating role of the pricing mechanism, or the "invisible hand," as Adam Smith so astutely recognized. But coordination is not equivalent to governance, a fundamental point that is often overlooked. Coordination takes place within a context defined by a set of laws and institutions, where the invisible hand can function quite impersonally and efficiently. However, the invisible hand does not ordinarily have the power to change those laws and institutions; i.e., it does not have the power to govern: that job is left to a political authority. In capitalist societies, the political authority functions as the visible hand of capitalism as well as government. The powers and abilities of a political authority are distinct from those of a coordinating mechanism. For example, government may elect to tax gasoline, either for purposes of raising revenues or to promote conservation, while the invisible hand is not similarly empowered. The invisible hand, in turn, can reestablish equilibrium between supply and demand without the help of government and indeed regardless of the level of any such tax.

Economic development through time depends in part upon the capacity of a society to refashion its laws and institutions when circumstances shift, as Douglass North et al. have so ably pointed out.[3] This implies that the political authority must have the power to assert the last word in establishing the institutions of both the economic and political systems, including the power to modify market prices in accordance with laws and regulations. While I describe both capitalism and democracy as systems of governance, their powers are not coextensive. Government has a different and ultimately super-ordinate set of powers to exercise, and this book aims to spell out those essential powers of problem solving, as well as some of their familiar limitations.

In drawing a parallel between capitalism and democracy as systems of governance, and in calling attention to their interactions, I rely on the ideas of two very distinguished political scientists, Gabriel Almond of Stanford and Robert Dahl of Yale. Almond puts forth an overall proposition concerning the roles of these two systems in contemporary societies: "The economy and the polity are the main problem solving mechanisms of human society. They each have their distinctive 'goods' or ends. They necessarily interact with each other and transform each other in the process."[4] Dahl, in turn, characterizes the relationship between these two systems as one of "antagonistic symbiosis," since their mutual effects can both support and

[3]See Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge Series in the Political Economy of Institutions and Decisions (Cambridge: Cambridge University Press, 1990).

[4]Almond, "Capitalism and Democracy," 467.

undermine each other.[5] Much of that antagonistic symbiosis is manifested through competition for power. In this introduction, I follow Almond's lead, while I incorporate Dahl starting in Chap. 3. Throughout the book I frame competition for power as inevitable in a context where two partially competitive problem-solving systems exist side by side.

The coexistence of these two systems of governance is complicated by their having been built upon indirect governance—or coordination through regulated competition in markets—as the key coordinating mechanism among various actors. Capitalism operates through two sets of markets, one for goods and services and a second for the factors of production (e.g., land and labor), but the political system also has two sets, one for the nomination and selection of candidates for office, and another for fashioning legislation. The political and economic systems can operate simultaneously within the same society because they operate in partially distinct domains; at the same time they can and inevitably do influence each other. Indeed, participants in one system can use their positions in that system as a base from which to compete for power in the other.

Defining the Role of Political Authority

Neither capitalism nor democracy is easily defined; indeed I did not find a standard definition of either. I will provide and explain an original definition of capitalism in the next chapter, an attempt that I believe to be one of the most important contributions of the book. As a first approximation, capitalism requires more than the existence of trade in goods and services; it also requires that the factors of production, such as land, labor, and capital, are free to be reallocated in markets in much the same sense that goods and services are. As this book's focus is on capitalism, I make no claim to provide an original definition of democracy, relying instead on Robert Dahl. Here and throughout the book, I assume democracy implies that power in the political system rests with political leaders who are held accountable to a free society through periodic elections. I contrast democracy with oligarchy, a condition where significant political power is vested in the economic system and is not necessarily held publicly accountable.

With these provisional definitions, we can proceed to assert that capitalism and democracy share a common political authority in government, which articulates and enforces the rights and responsibilities that support both systems. At the same time, both of these systems of governance are primarily indirect in that they create institutions and establish rules for acceptable behavior without attempting to directly plan or control the bulk of the actions or actors—whether economic or political—in their respective domains. Indirect governance relies in large measure upon decentralized markets to facilitate citizen participation in the shaping of economic and political choices for their respective domains. In the case of capitalism, economic

[5]Robert Dahl, *On Democracy* (New Haven: Yale University Press, 1998), 166. Copyright © 1998. Reprinted by permission of Yale University Press.

markets are shaped by economic institutions (such as prices and profits) and regulatory controls on the use of resources; political institutions define the rules of acceptable behavior for elections and legislative markets in the case of democracy. The workings of these decentralized markets in turn underscore yet another similarity between the two systems: both are *emergent* in that societies, through their governments, have the capacity to refashion their problem-solving systems from time to time by peaceful means.

These two governance systems maintain distinctive centers of power and pursue different purposes. Firms and business associations are the centers of economic power in the case of capitalism, while governments and political parties are the centers of political power in the case of democracy. Firms typically have private purposes and thus relatively narrow constituencies: governments have public purposes and thus rather broad and partially competitive or even conflicting constituencies. In practice, the boundaries between these two systems of governance are not necessarily clear-cut; actors may shift from one system to the other and their respective purposes are not always separable. These ambiguities stem from the fact that both capitalism and democracy exercise power within a single society where their powers are intertwined. As an inevitable result, these two systems are partially competitive and can easily corrupt one another.

Which Came First?

Despite their co-existence in many contemporary circumstances, capitalism emerged as a system of governance before any modern democracy. At the same time, it is important to note that trade in goods and services (and labor) and small-scale governance through tribes (such as in the early Greek city-states) existed well before either. What concerns this book, however, are the modern systems of capitalism and democracy and their relation throughout history. Large-scale or modern representative democracies are more recent creations than capitalism, typically lagging by a century or more. In fact, modern democracy has historically *required* the prior emergence of capitalism; a decentralized economic system seems to have been a prerequisite for any large-scale decentralized political system. One quasi-exception to this rule seems to have arisen in the early United States, where, broadly speaking, the two systems emerged almost simultaneously; the early settlers imported British ideas of a nascent capitalism that accepted slavery and, in some cases, feudal land rights, as well as British ideas of limited monarchy as they had existed prior to the notions of the divine rights of the Stuart dynasty during the 17th century. While capitalism was thus a prerequisite for democracy, limited monarchy was at the same time a prerequisite for capitalism in England, the Netherlands, and Venice, as we will see.

The particulars of which system is the older may seem to be academic quibbles from a contemporary perspective, but the relative origins of these two systems play an important role in determining how each system shapes the other, initially and over time. Moreover, they help determine the extent to which actors in one system may *legitimately* regulate or impose conditions on actors in the other. Chapter 13 provides an illustration of these issues with respect to the case of the United States in the 19th century, where capitalism was seen by influential members of the legal profession as not only a pre-existing system of governance, but also quite separate from the political system. As a result, conditions placed by political authorities upon capitalist actors were seen as illegitimate, an outcome antithetical to the argument of this book.

In discussing the emergence of capitalism throughout this book, I emphasize the establishment of markets for the factors of production as the defining feature of capitalism, and one requiring political decisions everywhere that it occurred. As a result, I conclude that the emergence of capitalism seems to have been an achievement of a state rather than a natural occurrence that might be achieved by markets alone. I explore this set of circumstances in the European context in Chap. 5, contrasting this European experience with Japan, China, and the Ottoman Empire. Capitalism did not spread like trade during that first era of the opening of world markets. Indeed, there were geographic differences in the adoption of capitalism, as illustrated in Chaps. 6 and 7, where I compare the development of South America and North America following their respective settlement by Europeans, starting in the 16th century. In each of these cases, economic change required political change, and capitalism could not come about without a certain measure of political liberalization. To claim the existence of capitalism prior to or independent of the decisions of governments is to reduce capitalism to trade or simple economic exchange, overlooking its reality as a much more institutionally rich system of governance which includes the factor markets for land, labor, and capital.

The Integral Importance of Institutions

Thus far I have described capitalism with little mention of firms, surely one of the key indicators of such a system. Here and throughout the book, I focus less on firms as economic actors than on the economic and political institutions which define the systems of governance through which those actors are enabled and constrained; in my conception of capitalism as a system of governance, firms are more nearly dependent actors than the "free enterprises" of common discourse. In other words, when viewed from the point of view of how a capitalist system works, firms are only free to act so long as they act within the limits established by that system. All of their freedoms are conditional upon a grant of authority from a political entity, typically from a state, and often in the form of the terms of a legal charter of incorporation issued by the state. Firms can acquire great economic power and thereby challenge the authority of the state, a situation that I illustrate in some detail in the US context in the 19th century in Chap. 13. Specifically my interest in this book is less on how firms exercise their powers so as to grow and develop as profit-making entities than on how firms and political authorities interact with each other in the two systems of governance.

The relationship between political and economic actors is one of mutual influence. For instance, political authorities have it in their power to enhance the powers of economic actors, typically firms, by granting more generous terms in their corporate charters or by relying more on self-regulation by these actors. At the same time, political authorities also have the power, and arguably the responsibility, to demand accountability from those same firms. Economic growth and technological progress open the way for increased empowerment of firms, and, by the same token, firms are well placed to demand additional empowerment from government to take advantage of such opportunities. In these circumstances, a critical measure of the effectiveness of a capitalist system lies in the continuing adjustment of regulatory oversight by the appropriate authorities as the powers of the firms increase. It follows that, in this instance, political institutions matter just as much as, if not more than, economic. The political institution of a corporate charter serves as another apt example. In cases where firms have multiple sources of charters, as in the United States, where there are at least 50 chartering authorities, the terms of empowerment granted through charters may be quite generous or lax, as multiple authorities compete for firms to incorporate in their respective jurisdictions, thereby weakening the power of the political system over the economic system. This contrasts sharply with cases where there is only one chartering authority, typically central government, as in many other countries.[6]

Academic Specialization and the Misunderstanding of Capitalism

Despite such evident interdependence and shifting power relationships of capitalism and democracy, they are commonly studied in separate academic disciplines, including political science, government, economics, law, and history. In keeping with this academic specialization, some leading political scientists have pointed out that capitalism is a system of governance for economic affairs, while at the same time acknowledging that they are unable to say much more about it for lack of a deeper background in other relevant disciplines, such as economics.

At the same time, economists often remain within their discipline, focusing on the achievement of equilibrium of supply and demand as though this was the most appropriate indication of capitalist governance. While the existence of equilibrium is evidence of remarkable powers for spontaneous coordination of supply and demand through the price mechanism, capitalist governance also involves the design and/or shaping of the market frameworks through which that equilibrium is achieved. All too often economists finesse this issue of the design of market frameworks with the much overused expression that the guiding principle is, or at the very least should be, to achieve “a level playing field” among the competitors with the minimum omission of externalities or uncounted costs. However, the so-called level playing

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[6] Canada is an interesting exception, where it has a number of chartering authorities by province, but apparently little or no competition among them.

field of capitalism is more likely to be the exception than the rule, with the inclusion of all externalities a rarity if not an impossibility. Moreover, given the competing interests of the economic actors and their very different sizes and therefore differing economic powers, a level field is certainly not a universal goal for the economic actors. Nor is it necessarily a desirable one from the point of view of society as a whole; market frameworks can be "tilted" for legitimate policy reasons, as we will see throughout this book. There can be positive reasons to create such tilts, as, for example, when markets under-price a finite resource that is used by millions of consumers, such as petroleum or fresh water.

In reality, market design is a process of identifying desirable tilts for market frameworks in an effort to achieve policy goals that serve the people. One such goal may be to reduce and possibly remove grossly anti-social distortions, such as the obvious negative externalities of pollution of the air, water, or natural scenery. Equilibrium in distorted conditions is an indication of market failure, not success, though the failure may well begin in the political system. Whereas the level playing field has great analytic power in sports, it should be accorded much less deference when it comes to capitalism; in capitalism, the key distortions may come from the grossly different amounts of power available to the various competitors as they participate in the market design process, which is typically a legislative or regulatory process. Consider, for example, the relative powers of the issuers and users of credit cards: the former has far greater economic power to achieve change in the laws governing them, via lobbying.

Such unequal power relationships are an inevitable element in any capitalist system; but just how great these inequalities are allowed to become should be a key consideration in any analysis of the effectiveness of a capitalist system. Grossly unequal power may enable the strong to not just pervert the competitive discipline for private gain, but also pervert the political system. Asymmetries of power are the norm in capitalism, not the exception, a key distinction from the norm of a level playing field in organized sports. Thus, while asymmetries of information seem to receive the lion's share of attention in economic analyses, limiting the asymmetries of market power seem crucial to maintaining the long-term legitimacy of capitalism.

Academic specialization has arguably been an impediment to either defining or understanding capitalism. Economists may comfortably approach asymmetries of information as scientific problems; they aim to reduce or eliminate such asymmetries through the quasi-magic of transparency, as though power relationships have been all but eliminated through competition. But markets do not automatically reduce asymmetries of power, let alone eliminate them, and in many cases there is a policy-based tilt to a market by design. In tilting capital and labor markets for policy reasons, legislatures and regulators are not implementing a scientific process; they are making political choices that favor some interests relative to others. In so doing, political leaders are projecting an economic strategy that expresses political priorities. This amounts to an implicit form of governance that is often unacknowledged.

Organized economics has preferred to avoid recognition of political decisions and political power by assuming that all actors are basically rational and that rationality is by definition based upon economic self-interest. Implicitly this analytic logic devalues political science, sociology, anthropology, and the study of administration, all of which deal with power differentials as well as possible distortions in awareness and/or perception. As a result, economic analyses of capitalism invite big gaps in reasoning, and notably when it comes to treating the crucial power relationships to be found in the factor markets. Markets are presumed to be the legitimate source of authority, no matter the possible power imbalances in the institutions that shape those markets. The goal might better be to establish an appropriate policy tilt rather than leaving this issue out of the analysis.

Historically, this focus on markets was often appropriate. For instance, the metaphor of the invisible hand was fitting in the era of atomistic competition that preceded the Industrial Revolution, the era to which Smith applied it. Inequalities of economic power existed, but were typically miniscule compared to later times. However, when the same metaphor is applied to markets in a post-1840 context, it loses much of its fit with reality; grossly unequal power relationships rapidly became common in economic markets, not the exception. These gross inequalities challenge the very notion of an invisible hand. The hands of the giant actors are no doubt visible to the smaller players, even if perhaps not to scholarly researchers.

Imbalances of power create a conundrum. On the one hand, they are in part a manifestation of competitive success, and notably so in capitalism. On the other hand, great imbalances of power in economic markets invite not just corruption, but also possible subversion of the political system by those with great power. Although there may be no right answers when it comes to setting acceptable limits for inequalities of power, understanding the approximate magnitude of these inequalities of power, how they have been achieved, and how they have been maintained must be a fundamental requisite of any in-depth study of capitalism. Moreover, such a study must recognize that inequalities can be dramatically reduced by holding economic actors accountable through regulatory actions and fiscal policies.

Debates over the acceptability of particular levels of inequality implicitly question the desirability of different models or definitions of capitalism. Some inequality is obviously desirable to enable the effects of successful competition to make a difference in asset allocation, economic growth, and compensation. Furthermore, there are no accepted criteria for saying how much is too much and thus requiring regulation. Nor are there clear criteria by which to define or classify capitalist models, though some authors have identified two “varieties of capitalism,”[7] and one could add additional variants in the same dimension that they use, i.e., between laissez-faire and a more protective, “social democratic,” and therefore egalitarian model.

[7] Here I specifically refer to Peter Hall and David Soskice, whose work, particularly their *Varieties of Capitalism* (Oxford: Oxford University Press, 2000), I will discuss in more depth in Chap. 4.

Given these circumstances, it should come as no surprise that some good studies on capitalism have very incomplete definitions of the term, while others fail to define the term at all: I will make reference to several such works as we proceed. However, the more important point is that most existing definitions of capitalism fail to see it as a system of governance; instead, they see it is a system of markets. While capitalism is indeed a system that encompasses markets, those markets do not themselves comprise a system of governance, which is the distinctive focus of this book.

Organized Team Sports Are a Very Valuable Analogy

Certain conceptual and analytic gaps persist between conceiving of capitalism as markets, wherein economic actors develop and distribute products in competition with one another, and as a system of governance for economic relationships more broadly. While inter-firm competition is a central feature of capitalism, the system itself is built upon a set of institutional relationships that provide an infrastructure as well as a set of rules and regulations. In this perspective, a capitalist system must have rules and referees to police the competition as well as a political authority to preside over the system and make institutional changes as needed. In defining this broader and more historically rooted conception of capitalism and providing an explanatory theory of how it works, I have found that the example of organized team sports proffers an invaluable if imperfect analogy. The analogy is described in full in Chap. 2, but I will introduce it here.

The key to understanding the governance of organized sports is to recognize that the play of the contestants is based upon conditional grants of freedom, not absolute freedoms as implied by the term "free enterprise." The actors in capitalism, as in organized sports, are allowed to pick their own strategies, but they are only "free" so long as they obey the laws and regulations of their society.

The notion that government is merely an administrator, providing national defense and monitoring of the home markets, is a remarkably inadequate perspective through which to understand modern-day capitalism. The political authority of any system of organized competition, whether for sports or economic activity, must be an *innovator* as well; it must be able to modernize the institutions of capitalism such that the economic system can adapt to a changing economic, technological, and political environment. Thus, government clearly has an innovative or entrepreneurial role as well as its more familiar administrative role. Recognition of this entrepreneurial role of government suggests the need to study the purposive behavior of political actors, i.e., their strategies.

It is axiomatic that all organized sports require rules and referees; they are the sine qua non of organized sports, as contrasted with informal sports. However, to see the regulations and other institutions of capitalism as part of a system of governance means to recognize that they may, and in fact usually do, have purposes beyond maintaining orderly competition. They can promote differing styles of competition, just as countries can promote different national brands of football, e.g., Australian, Canadian, and American. In the realm of capitalism, institutional frameworks inevitably embody different strategies, some emphasizing increased economic productivity and others emphasizing social goals such as equality and due process. An example of the former is that of laissez-faire capitalism, which posits the notion that Schumpeter's "creative destruction" is an appropriate way to deal with social as well as economic priorities. Although this model of capitalism is oft assumed to be a given, as if there was a single best strategy for all societies, it should be recognized as the strategic choice that it is, subject to debate and possible political contestation. More broadly, it should be assumed that some institutional arrangements will be more appropriate to implement a strategy of efficiency and stability, a strategy of income redistribution to reduce inequalities, or one of the promotions of economic growth. The notion that there can or even should be a single model that fits all situations, as implied by those who were enthused by the Washington Consensus model in the 1990s or who continue to embrace laissez-faire economics today, finds little support in this perspective.

The Structure of This Book

The layout of this book might suggest that my definition of capitalism set the stage for a subsequent historical study of how capitalism emerged and developed. In fact, as I pointed out in the Preface, the historical analysis gave rise to my definition. It was only after many years of analyzing the economic strategies of different countries with different political systems in their historical contexts that I conceived of my definition. These cases, taken together, inspired my theory that both capitalism and democracy are indirect systems of governance relying upon conditional freedoms to structure voluntary behavior, like in organized sports, rather than upon direct command and control to mandate obligatory behavior through a hierarchy, like the organization of a firm or bureaucracy. I developed this definition inductively by observing relationships and developmental trends in a series of case studies that comprise this volume.

I began the book with a Prologue. I sketched a brief comparative study of the use of zoning laws to regulate land usage in England and the United States in order to illustrate how capitalism and democracy can function distinctly from one country to another, or even, within a single state, from one county to another. Specifically, the national government in Britain regulates zoning for large blocks of land while that responsibility largely falls to local governments—cities and towns—in the United States. Accordingly, large firms such as Wal-Mart can overpower zoning officials in the US localities much more readily than they can in England. The consequences of the powers of zoning boards are readily observable to tourists as well as real-estate investors in England and the United States. I use this example to illustrate how institutions that were established in one era can continue to exercise a very large influence more than 200 years later under radically different conditions. Each subsequent section of the book opens with a prologue which illustrates or describes the animating issues of the section's chapters.

Chapters 2, 3, and 4 form the theoretical core of the book. Chapter 2 presents an original definition of capitalism and a theory of how it works as a system of governance. It is the conceptual heart of the book and for some readers it may be difficult. However, my argument does not make use of any algebra. In contrast to simpler notions of a self-regulating system, my definition puts forth a model of indirect governance of markets by a political authority through political, economic, and even social institutions. In elaborating on my definition, the chapter explains how the granting and monitoring of conditional freedoms lies at the heart of capitalism, how the institutional frameworks of the factor markets play a primary role in this process by forming the base for industrial policies granting different powers to different actors, and thus, how different policies give rise to different varieties of capitalism. Finally, an appendix to Chap. 2, at the end of the book, brings the firm into the discussion to show the tension between capitalism—of any variety—and the political system, where economic actors may influence and even corrupt their political counterparts.

Chapters 3 and 4 introduce democracy and power relationships to show that there can be very large differences between government *by* the people and government *for* the people and that these differences emanate from the institutions that have accumulated through time. The study of democracy in relation to capitalism and the study of the development of power relationships are essential to any modern study of capitalism itself. The collective point of these three chapters is to show, albeit in different ways, just how much the performance of a capitalist system is based upon political, economic, and social power relationships that are not well captured in the equilibrium frameworks of neoclassical economics.

Chapters 5, 6, and 7 are historical case studies. They take up the origins of capitalism and its early evolution, focusing on the period prior to 1830. Chapter 5 brings my conception of capitalism to bear on the circumstances that led to the origins and initial emergence of capitalism in Europe. I use this chapter to introduce the curious notion that capitalism did not spread based upon theory or dogma, as one might anticipate from the way religions spread. Instead, it appears to have emerged from competitive struggle in a particular—indeed, an almost unique—set of circumstances. In this analysis, I follow the lead of historians who, like Fernand Braudel, have typically located the origins of capitalism in Europe, during the period 1400–1800, in the struggle of 300–500 mostly feudal entities to maintain their separate identities as their number was gradually reduced to 40 at the end of the Napoleonic Wars, around 1820.[8] This competitive winnowing to a small number of still competitive entities followed a process much like that which has characterized the development of many industries in modern times. It was a relentless competition for survival, drastically reducing the numbers of survivors through mergers, acquisitions, and hostile takeovers, while still leaving far more than one or two in a

[8] Such historians include Fernand Braudel, to whom I refer in more detail in Chaps. 2 and 5.

circumscribed geo-political region, and it was unique to Europe. Other areas, such as China, India, Japan, and the Ottoman Empire, came to be dominated by a single great power. As part of this chapter's analysis, I re-examine a wonderful question posed by Fernand Braudel in his three-volume work, *Civilization and Capitalism in the 15th to the 18th Century*, namely: "What led to the 'rise' of Europe in this period?" The answer, I argue, lies in human agency coping with a very prolonged set of competitive challenges in a context where no single political authority ever completely won out during these formative centuries, a thesis which is not new or original but, nevertheless, of profound importance to the remainder of the book.

With this background established, Chap. 6 examines the European colonization of South and North America, beginning in the 16th century. Here an apparent paradox arises. Although the Europeans settled in South America about a century before North America, attracted to the former's apparently superior set of natural endowments, it was North America that ultimately pulled ahead in terms of economic development around 1750–1775 and that has remained ahead ever since. Capitalism appears to have been a factor in this reversal of economic leadership, as it appears to have taken root almost immediately in North America, the poorer area, while it did not take root in South America until the 19th century. Why would the lower-income region take the lead in pioneering capitalism and, as it were, in pioneering large-scale democracy as well? Moreover, why would it employ these two governance systems to such effect that it was able to pass the higher income regions of not only South America, but also its "mother country," whether England or Europe more broadly?

Chapter 7 takes on part of this broad question, asking why the lead in North America appears to have come from New England in the 18th century, when this was a region that was poor even by North American standards. Indeed, for the first 150 years of European settlement, 1630–1780, New England had negative net immigration from Europe, as more settlers left than came. The explanation for the region's surprising lead, it seems, resembles that for Europe's success: hardship, and the corresponding need to struggle to succeed, forged conditions seemingly more favorable to long-term progress than the existence of rich factor endowments with their quasi-automatic comparative advantages. Creating an effective organization to earn new wealth was more conducive to long-term success than finding wealth in the ground and capitalizing on it through a strategy based upon obvious comparative advantages. Was a strategy of building domestic capabilities through diversification more advantageous than one based upon specialization and trade, if the latter limited the avenues for human development and institutional innovation? In analyzing the role of factor endowments and comparative advantage, I am indebted to the work of economists Stanley L. Engerman and Kenneth L. Sokoloff.

In Chaps. 8 and 9, I explore and analyze how two "modern" societies developed two social systems, side by side, demonstrating the potential for variants of capitalism to persist within a single country. In Chap. 8, I study the case of Italy, where the northern region is today modern, prosperous, and democratic while the south lags. Economic theory predicts that two such market-based systems, north and south, should experience a convergence of average incomes, but this has not happened over a measured period of about 150 years. Free trade within Italy has not brought about the reallocation of resources that theory would predict, because its southern markets are distorted through the existence of extralegal patron–client relationships that continue to thwart development, decade after decade. Similar observations can be made about the United States after the Civil War, the subject of Chap. 9. In spite of the abolition of slavery and a 12-year period of "Reconstruction," the US South created and maintained a distorted social system where much of its human capital was denied political, social, and economic opportunities. So-called free markets for goods and services were not remotely enough to offset the institutional distortions of segregation, at least until 1940. This analysis might suggest the limits of the free trade model in our own era, as, for example, in the NAFTA paradigm. Trade may provide a superficially attractive veneer for development, but capitalism requires the development of human resources and effective domestic institutions through access to education, infrastructure, and above all legal protections, all of which require an effective state.

With these two seemingly anomalous models accounted for, I then spell out three well-known economic strategies in Chaps. 10, 11, and 12. Namely, I discuss import substitution, the Washington Consensus, and "enhanced resource mobilization" or neo-mercantilism. Through analysis and supporting cases, my discussion of each strategy is connected to the central tenet of this book, i.e., capitalism as a system of governance wherein societies can employ quite different strategies. The Washington Consensus is but one of those strategies; a deregulated version of capitalism, it may have much less to recommend it than has been commonly supposed. It exemplifies, as economist John Williamson has aptly observed, a policy prescription that can be derived from neoclassical economics in a world where government is assumed to play a minimal if essential role.

Chapters 13 and 14 focus exclusively on the case of the United States, examining the active transformation of the US systems of governance, capitalism, and democracy, and the links between them. Indeed, writing Chap. 13 was of great value in consolidating my theory of human agency driving the capitalist system. The world's most egalitarian society when de Tocqueville visited in 1830, the United States became a very different, even oligarchic society by the 1880s. Drawing on the work of Charles Perrow, Morton Horwitz, Duncan Kennedy, and Robert Jackson, I explain why and how US capitalism was transformed in the latter-19th century to allow for such growth and subversion, and why this growth was not corrected in adequate measure through the regulatory powers of government, particularly when the United States seemed to be governed by a vibrant if young democracy. The US capitalism was shaped by human agency not only in the creation of new forms of corporate organization, such as vertical integration, as identified by Alfred Chandler, to achieve increased economies of scale, but also by new legal powers that enabled firms to lock in capital and return it to shareholders only at the will of the board of directors. In addition, competition in regulatory laxity opened the nation to the abuse of power by the big firms in a pattern that may be a model for the future of regulatory oversight in the global economy in years ahead. Human agency was clearly key in reestablishing the control of the legislative agenda by the Congress after a confrontation between the President and the Supreme Court brought about some personnel changes in 1937, an event that marks the chapter's conclusion.

Chapter 14 examines a strikingly similar transformation during the 20th century, when, after a period of greater equality postWorld War II, the United States again came to resemble an oligarchic regime, circa 1980, after a period of social, political, and economic deregulation. If these two transformations in systems of governance bore striking similarities in the rise of an economic oligarchy that threatened legitimate democracy, the particulars were remarkably distinct. In the 19th century large-scale enterprise outgrew the regulatory powers of the states, while, in the late-20th century, the US federal government's strength was unparalleled, though it was experiencing declining political capacities to govern. The latter reestablishment of this oligarchic model, i.e., laissez-faire economics, in the 20th century was not the work of a small number of great industrialists and their lawyers, as it had been in the 19th century. Instead, it was the work of a series of unrelated events in the US social and political systems that systematically reduced the role of social and political authority at both the federal and state levels, thereby setting the stage for radical deregulation of the economy. Notably, in this context of a weakened state, the US financial sector was able to exert a remarkable influence over the rest of the economy, increasing its share of corporate profits from less than 16% before 1980 to more than 40% by 2002 and deepening the roots of the financial crisis that emerged around August 2007. This is an exceedingly complex topic, and one which needs a great deal more study before it yields insights as strong as those we can draw from the story of the 19th century. Partly as a result I found Chap. 14, the last historical chapter, by far the most difficult. I wrote it with the awareness that, even having lived through this era and even taught many classes on "current events" to graduate students, I still lack the historical perspective needed to provide either a comprehensive or a conclusive story of this latest transformation of US capitalism. Indeed, an account of a very recent—and, indeed, current—event in American history, the financial crisis of 2007–2009, is appended in an Epilogue, so as to provide some distance between recent historical analysis and ongoing events. Sandwiched between Chap. 14 and the Epilogue is a chapter of overall conclusions.

The United States as a Special Case

Of all the countries studied in this book, the United States is given the most textual attention. I devote four full chapters and an epilogue to the case of the United States, and almost half of the text, because the story of its inception, its one country with two systems—one slave and one free—and its two overall transformations is remarkable. The United States is something of a special case, both in its early adoption of capitalism and in having embraced laissez-faire capitalism for almost 90% of the nearly 400 years of its existence, as I describe in Chaps. 7, 13, and 14. Only England can rival its early adoption of capitalism, and only England has a claim to shared leadership in adoption of the laissez-faire model as well.

I raise these obvious points here at the outset to alert the reader to the point that, while many Americans consider the period 1937–1980 to have been an aberration which is best forgotten and certainly not repeated, it is during that period that the US model of capitalism was most similar to the models extant in other countries. The period since 1980 has given many Americans the sense that the United States has returned to its true roots, while most other recent versions of capitalism are quasi-socialism. Given this perspective of an exceptional heritage, and likewise a successful and indeed uniquely powerful economy, many Americans have shown little interest in learning much about other economies. Indeed, for many American business executives, the US capitalist model of today (i.e., laissez-faire economics) is the only model worth studying. The focus of the studies of some of the leaders of this typically conservative establishment has been how to make US capitalism still more true to the laissez-faire model extant circa 1880–1933.

American exceptionalism, and an accompanying American lack of interest in other capitalist models, have been a prominent presence in our classrooms here in Boston at least since the start of the war in Iraq. As a teacher in a Harvard Business School executive program for Owner-President-Managers over a 20-year stretch, I encountered this divide in the perceptions of business executives in successive classes, while hearing of it from foreign participants in our most senior executive program, the Advance Management Program, on a number of occasions as well. These observations have also been confirmed by a number of faculty colleagues in those same programs, and by numerous students in our MBA Program, where I have taught for the last 25 years. My point is twofold: non-American participants believed that a chasm existed between most, though not all, American executive participants and most of the non-Americans, and the Americans showed little interest in hearing about let alone inquiring about possible reasons for its existence. Some Americans were clearly impatient with the idea of taking class time to consider any such differences, even while their foreign classmates often welcomed it warmly. I will return to questions such as these at the end of the book, and specifically to ask whether the American laissez-faire model of capitalism has been advantageous for the United States to follow let alone for others to emulate.

Chapter 2
The Concept of Capitalism

Any study of the rise of capitalism, of its origins and evolution, necessarily presupposes a certain conception of capitalism. It is the purpose of this chapter to put forth the conception upon which this book's study of capitalism is based, namely: *Capitalism is an indirect system of governance for economic relationships*.

To understand capitalism as an indirect system of governance is to transcend the boundaries of standard neoclassical economic analysis, moving beyond merely the markets of pure economics to include the institutions and authorities of political economy. Such an understanding requires a more holistic analytic approach, one including insights from political science, sociology, and the law. While there could be a number of causes for the apparent difficulties in arriving at a consensus definition of capitalism, it is at least partly due to the question of other attempts being limited by the bounds of a single academic discipline, typically economics.

There is little reason to suppose that defining how a system of governance works should be easy, and a number of distinguished scholars have made important contributions toward such a definition. Adam Smith provided a remarkable insight into how the markets of capitalism can coordinate the actions of literally thousands or millions of people, without any conscious guidance on the part of the quasi-independent economic actors, as it equilibrates supply and demand through the price mechanism. And it was about a century later that neoclassical economics emerged, when a small group of British economists recognized that it was the markets themselves that established the values of various good and services, rather than the intrinsic properties of these items themselves.

These discoveries, path-breaking as they were, remain insufficient as a working definition or understanding of capitalism, since they tend to focus on the achievement of market-based equilibrium as though it, by itself, stands for economic governance. However, the realities of market economies have shown time and again that equilibrium can be achieved in distorted markets where supplies include goods produced by slaves or other forms of forced labor, in speculative bubbles where excessive leverage permits buyers to generate unsustainable levels of demand or supply or, on the contrary, in depressed markets where effective demand is far below a nation's capacity to produce. For equilibrium to be a true reflection of effective societal governance, market prices must reflect true social costs (i.e., factor in the value of the goods and services to society as a whole), and demand

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must reflect sustainable demand without the use of undue financial leverage by the borrower or the lender (i.e., factor in the long-term as well as the short-term demands).

However, it is not the role of the market actors to decide what costs and benefits are to be included in a market price; instead, those cost-benefit decisions are shaped by government and typically by legislatures. Imperfections, such as externalities, are the rule and not the exception; indeed they are to be expected of a system where imperfect political markets inevitably lead to imperfect legislative solutions that then impose imperfect institutional frameworks to underpin the economic markets. Only a political authority can correct these market frameworks, and this in itself should warn us that externalities will never be eliminated, and in the meantime can create distortions that range from small to large, and even "extra-large."

Thus, it really matters to think of the economic markets of capitalism as part of a system of political economy and not just one of economics. My conception of capitalism broadens the focus from market operations to the institutions that shape the market frameworks and the political authority that governs the institutions as well as the markets, and thus encompasses political economy rather than the narrower notion of pure, mathematical economics. In proposing this conception, I aim to illustrate the idea that the evolution of a capitalist system is as much a political phenomenon as an economic one, and specifically that it requires the visible hands of political actors exercising power through political institutions, such as elections and legislatures, in activities that are remarkably different from the unguided or invisible hand that Smith so astutely recognized.

Unlike most chapters in this book, this chapter is predominantly theoretical; it aims to establish the framework for the historical case-based chapters that follow. After a brief overview and critique of current conceptions of capitalism, I delve into the details of my own. I organize this discussion around the major characteristics of capitalism: (1) Capitalism is an indirect system of governance; (2) capitalism is analogous to organized sports; (3) capitalism is comprised of three levels—markets, institutions, and political authority; (4) the third level of political authority underscores the role of visible human agency, not just that of invisible market forces, in capitalism; (5) the political authority has the administrative opportunity and in many cases the responsibility to shape the capitalist system to favor certain interest groups over others, as well as the entrepreneurial responsibility to modernize the capitalist system over time; (6) capitalism is a system of governance not only for private goods but also for public or "common" goods, where some of the most important of those common goods are the market frameworks themselves, and political authority, not market forces, is essential for governing the latter; (7) political authority inevitably shapes capitalism according to a strategy, no matter how implicit or imperfect that strategy might be; and (8) political and economic markets determine the nature of political authority, such that the political system of governance and the economic system (i.e., capitalism itself) are not only interdependent but also a theater of competition in which economic and political actors compete with each other for power.

I conclude with a summary of the chapter, restating my definition of capitalism in more simple terms and suggesting implications to follow in the rest of the book.

Historical Conceptions of Capitalism

Historians, most notably Fernand Braudel with his three-volume *Civilization and Capitalism*, have traced the origins of the term capitalism to the mid-1800s.[1] However, its notoriety came a few decades later, from socialists who used the term to describe what they disliked about the workings of liberal markets. Karl Marx, arguably one of the most prominent socialists of the time, invoked the term in reference to a system of markets that in his view favored capitalists at the expense of society.[2] His notion was, of course, conditioned by historical experience up to his own time, as well as his own perspective on that history; when he was writing, markets appeared to inevitably pit capitalists against the proletariat, without much regard for the fact that a democratically-elected government, or even a limited monarchy, might intervene to protect the interests of the middle classes let alone the poor. In his era in both the United States and Europe, capital was achieving extraordinary power for the newly emergent industrialists. For example, the largest firms in the US grew from fewer than one hundred employees in 1800 to more than one hundred thousand a century later, and they grew still more in terms of the financial and physical resources at their command, as we will see in Chap. 13. This extraordinary accumulation of private power called for a new conception of capitalism; Adam Smith's atomistic capitalism, where firms had little or no economic power, was hardly an adequate framework for such analyses. At the same time, there were virtually no large-scale democratic states until almost the end of the 19th century; Britain enlarged its electorate from about 1.5% of its population to 2.5% in 1832, and then only by the late 19th century began to add wealthy merchants and manufacturers to its class of wealthy aristocrats. The US was the outstanding exception, as Alexis de Tocqueville recognized during his firsthand study of the nation in 1830. But the fact that governments had not mounted much by any of successful attempts to embed markets in regulatory frameworks to protect labor, a critique brought up by Karl Polanyi and discussed in Chap. 3, did not mean that they could not do so, as Marx implied, but only that it had not yet been done.

Despite its grounding in a particular historical context, Marx's critique became an influential understanding of capitalism during the mid-19th century, and his ideas served as a sort of handbook for revolutionary activities and notably a covering

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[1]Fernand Braudel, *Civilization and Capitalism, 15th–18th Century*, trans. Siân Reynolds, vol. 2: *The Wheels of Commerce* (Berkeley: University of California Press, 1982).

[2]A lucid description of some of the history, though mostly in a US context, may be found in Michael Merrill, "Putting 'Capitalism' in Its Place: A Review of Recent Literature," *The William and Mary Quarterly* 52, no. 2 (April 1995): 322 ff.

ideology for those who wanted to establish totalitarian regimes to suppress the power of the capitalists, thus allowing a few to govern in the name of the proletariat. In such a context, capitalism was hardly a term of approbation. Indeed this competition for ideas and for power was clouded by the fact that capitalism had been defined by its adversaries more than by its proponents. Indeed, its proponents were preoccupied with resolving differences between utopian views, such as those of Robert Owen, with the near-opposite view of laissez-faire capitalism, which assumed market outcomes were based upon a system that predated government and were therefore not to be disturbed by government, with rare exceptions. The democratic alternative to both sets of views had yet to show either in theory or practice that it could create market frameworks meeting Polanyi's challenge.

This very brief introduction to the history of capitalism in the 19th century is only intended to suggest that, by the late 19th century, it was a rather imperfect alternative to feudalism, in fact creating a new order that was open to huge concentrations of power that simply replaced those of the earlier order. Thus, ironically, capitalism came to be defined by some of its critics as the rationale for a centrally planned, coercive state that would monopolize power even more than its feudal predecessor. Although the democratic capitalism that we tend to take for granted today already existed in a few places, such as the United States, its existence was pushed into the shadows by the obvious presence of the new industrial giants, until reform finally came, in the mid-20th century. As mentioned in Chap. 1 and discussed in depth in Chaps. 13 and 14, democratic capitalism has been challenged almost since its inception by oligarchic capitalism.

Over the last century and a half, the prevailing conception of capitalism has undergone a rather remarkable evolution, in terms of both its inherent structure and its impact on societal outcomes, both of which are of direct import for this book. A century or more ago, the notion that markets were political as well as economic constructs was obvious; indeed, economics was then called political economy. At the same time, capitalism was a little used term, except as an epithet by its critics. Since then, economics has gradually narrowed its focus from political economy to economic relationships. From there, the focus has narrowed further to economic relationships that can be mathematically modeled, as though economics were a science devoted to the discovery and exposition of a system of natural laws. From this narrowed perspective, microeconomics has become the study of how markets—traditionally, the essential institution of capitalism—coordinate decentralized decision making through a price mechanism to bring supply and demand into equilibrium without any explicit human agency or planning. Economic actors are presumed to interact on the basis of rational self-interest in a largely self-regulating economic system controlled by the laws of supply and demand. Rational self-interest is presumed to be universal and context-free (not to mention bubble-free), as are the laws of supply and demand. And capitalism, though based upon property rights created by human agency, is presumed to be able to achieve optimal outcomes for society without the benefit of explicit human agency, as though markets were controlled by natural forces akin to those of a gravitational field, a claim that might have been plausible in Smith's era, but surely not in our own. In the terms to be used in this chapter, microeconomics and the prevailing conception of capitalism are now largely focused on markets alone. As this market-based conception of capitalism is one with which my definition most strongly contrasts, I find it appropriate to describe and then critique it here, before introducing my own view.

Current Conceptions of Capitalism

As I suggest above, many economists and even many historians today tend to equate capitalism with markets, and markets alone. Capitalism, for them, is a system of natural forces, e.g., supply and demand that tend toward equilibrium. Notions of governance, let alone government, have no place within this impersonal, "scientific" system and are, in fact, often accused of corrupting or distorting capitalism. The strength of this market-based conception of capitalism has been apparent for many years, as highlighted by social historian Michael Merrill over a decade ago. In a 1995 review of contemporary conceptions of capitalism, Merrill pointed out the prevalence of the market-based conception and the challenges inherent in overcoming it: "If capitalism is little more than a synonym for a market economy, then any opposition to capitalism necessarily becomes an opposition to markets—in other words, an opposition so rarified and unreasonable to most people as scarcely to matter historically."[3] But such opposition is crucial, he asserts, because capitalism is not simply a product of economics but of *political economics*.[4]

Thus far, I agree with Merrill. However, I feel that his argument ultimately disappoints in that he does not propose a sufficient alternative conception. For him, "Capitalism, properly speaking, is not just an economic system based on market exchange, private property, wage labor, and sophisticated financial instruments . . . Capitalism, more precisely, is a market economy ruled by, or in the interests of, capitalists."[5] This second conception, while somewhat of an improvement on the first, fails to capture the actuality of capitalism in two key ways. First, it assumes that the interests of capitalists not only *do* prevail but *should* prevail in any capitalist system; it overlooks the possibility and even the desirability of governing markets in the interest of society as a whole. Second, it presupposes a notion of governance without explicitly recognizing the actual roles that human agents from the political sphere must play in a capitalist system if the market frameworks are to reflect the public interest through proper recognition of true social costs and benefits. Thus, Merrill leaves us with a critique of the market-based conception of capitalism without effectively moving beyond it. By tagging on the notion of the power of so-called capitalists, Merrill seems to be placing the theory of market-based capitalism in the context of what he sees in his own contemporary society; he does not ask if the

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[3] Merrill, "Putting 'Capitalism' in Its Place: A Review of Recent Literature." 317.
[4] Ibid., 317.
[5] Ibid.

contemporary context may be aberrant. But Merrill is certainly not alone in providing a clear and pointed critique, yet a less-than-robust alternative. Others have been equally unsuccessful in challenging the prevailing conception of capitalism, and, I believe, it is not least because this conception has been so effectively put forth by economists over the past half-century, notably Milton Friedman, whose work I review below.

The work of Milton Friedman, a Nobel Prize-winning economist who became famous as a leader of the so-called Chicago School, is perhaps one of the most important representatives of today's market-based theories of capitalism. In his much-cited book *Capitalism and Freedom*, Friedman takes a more focused and less historical perspective of capitalism than I do; he emphasizes a system for the coordination of economic actors through voluntary bilateral transactions in a marketplace. Friedman states that the main theme of his book is to elaborate on "the role of competitive capitalism—the organization of the bulk of economic activity through private enterprise operating in a free market—as a system of economic freedom and a necessary condition for political freedom."[6]

In his conception of capitalism, i.e., competitive capitalism, Friedman is primarily focused on trade, and he is much concerned about political freedom. He points to the economic freedom of markets as essential to its political equivalent, a proposition that finds strong support in the political science literature. However, for Friedman, political freedom seems to mean the absence of coercion of one individual by others:

> The fundamental threat to freedom is power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a momentary majority. The preservation of freedom requires the elimination of such concentration of power to the fullest possible extent and the dispersal and distribution of whatever power cannot be eliminated—a system of checks and balances. By removing the organization of economic activity from the control of political authority, the market eliminates this source of coercive power. It enables economic strength to be a check to political power rather than a re-enforcement.[7]

Essentially Friedman defines freedom as *freedom from coercion by others*, and implicitly assumes that those "others" are political actors and not economic actors. In other words, Friedman assumes that only government can concentrate enough power to threaten the freedom of individuals; the concentration of power in the economic realm, such as by giant firms, and its threat to the freedom of individuals, such as that of smaller firms or the employees of firms of any size, are omitted from his analysis, except for monopolies. Friedman overlooks the power of one firm to coerce another; specifically, when he assumes that competition eliminates economic power, he seems to overlook the fact that firms with thousands of employees compete with others that may have only one hundred employees or perhaps only ten. To speak of the transactions between giant firms and small ones as voluntary

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[6] Milton Friedman, *Capitalism and Freedom*, 40th anniversary ed. (1962; repr., Chicago: University of Chicago Press, 2002), 4.

[7] Ibid., 15.

and without coercion seems quaint, almost as though it could be used to describe bilateral encounters between a whale and a school of minnows, from the whale's point of view. Relative size does not necessarily equate with relative power, but to ignore the potential for unequal power relationships in the private sector, and to focus only on its exercise by political authorities, seems a considerable oversimplification. Overall, Friedman simplifies the reality of economic "freedom" by omitting consideration of the meaning of freedom to those members of society with relatively less economic power than others, in terms of meager resources, little education or human capital, and/or no financial capital with which to take advantage of market opportunities. Friedman seems to assume that inequalities in economic power are adequately controlled through competition, so long as most of the firms are privately owned, and that it is therefore only explicit inequalities of political power that must be avoided at all costs.

In point of fact, power relationships among individuals are rarely equal and, among various firms or teams of economic actors, even less so. Those with greater economic power can employ it as they bargain in markets or lobby political actors, while using even more overt coercion in less organized settings. In this more realistic perspective, economic power can be a force for the subversion of equality among persons, and thus a force for the subversion of freedom and democracy. To be compatible with democracy, and thus with the freedom of which Friedman conceives, capitalism needs to be modified or transformed in some way, as Robert Dahl has written.[8]

Modern economics has begun to recognize the narrowness of Friedman's vision, incorporating a notion of transformation into the study of capitalism. Specifically, in recent decades, formal economics has extended its field of study beyond markets to include the identification and examination of the institutional foundations of capitalism. Douglass North, a professor of economic history and recipient of the 1993 Nobel Prize in Economics, has been a pioneer in pointing out the need for such a change. As he implied in his Nobel acceptance speech: "There is no mystery why the field of development has failed to develop during the five decades since the end of the Second World War. Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operation of markets, not with how markets develop."[9] North proposes a broader perspective, one that includes the forces framing those markets, i.e., institutions. He explains in his work: "Institutions provide the incentive structure; as that structure evolves it shapes the direction of economic change toward growth, stagnation or decline."[10] In recognizing that institutions *shape* the direction of economic change, Professor North implicitly acknowledges that institutions affect markets in

[8]See Robert Dahl, *Democracy and Its Critics* (New Haven: Yale University Press, 1990).

[9]Douglass C. North, "For the Sveriges Riksbank Prize in Economic Sciences in Honor of Alfred Nobel," in *Nobel Lectures, Economics 1991–1995*, ed. Torsten Persson (Singapore: World Scientific Publishing Co., 1997).

[10]Douglass C. North, "Institutions," *The Journal of Economic Perspectives* 5, no. 1 (Winter 1991): 97.

ways that can mold the behavior of market actors and eventually the path of economic development as well. However, when he posits that institutions *evolve*, he does not take the next step to tell *how* they evolve and whether their evolution is a spontaneous process, like biological evolution, or one that is guided by human agency, like the construction of a road or a constitution.

What theories based on the work of Friedman and North miss is the idea of societal governance through human agency in capitalism. True, the evolution of the institutions of capitalism is partially a spontaneous process that can spread steadily on its own, like increased sales and geographic distribution for a product or increased diversification in the output of a firm. But it is also partially an intentional process; unlike changes to sales that happen gradually and largely at the initiative of the firm, changes to the institutions that shape markets depend in large measure on political as opposed to economic choices, as when a state promulgates a new set of regulations that require changes in behavior from the economic actors. Friedman, North, and many others miss this notion of agency because they focus more on the trading paradigm of capitalism (i.e., private parties transacting business in markets) than on its production paradigm (i.e., private parties mobilizing resources to develop technologies in search of profits and thereby potentially exercising great influence over the direction of the markets).[11]

A brief elaboration of these two paradigms is in order here, such that the oversight of these economists is well understood. The trading paradigm can be broken down by the actors and forces involved, as follows: Private parties are allowed to transact business in markets, including entry into and exit from specific activities, while the price mechanism balances supply and demand, a framework of laws and regulations governs the competition, and an accountable government provides security, administers laws, and modernizes laws as appropriate. The production paradigm can be similarly characterized in terms of its primary actors and forces: Private parties are allowed to mobilize resources through various legal vehicles such as corporations to develop and exploit new technologies in search of profits; corporations are permitted to lock in shareholder capital indefinitely at the discretion of the board of directors;[12] they are permitted the rights of self-governance through hierarchies; shareholders are shielded from losses through legislative grants of limited liability; managers are permitted to coordinate activities across functions and sectors through hierarchical organizations; employers are permitted to use implicit coercion, such as the loss of a job for employees who fail to carry out assigned roles; and competition for profits governs the allocation of resources and of internal rewards.

To ignore this second paradigm and see capitalism as nothing more than a system for trading is to see it only with one eye, effectively overlooking what is arguably the greater source of the gains in technology and growth for which capitalism is

[11]For a similar perspective, arrived at independently, see Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor*.

[12]Margaret M. Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century," *UCLA Law Review* 51, no. 2 (2003): 387–455.

known.[13] Moreover, to overlook the production paradigm is to overlook the primary opportunities for human agency within capitalism. The trading paradigm requires institutions to play a supporting role in governing the markets in which trade occurs; the production paradigm, in contrast, requires them to play a much more active role in establishing and monitoring a decentralized system of private power and thus, in turn, further requires human agents to play a decision-making role about the legal rights and responsibilities attached to such power. Put more simply, the former focuses on the product markets (i.e., for tradable commodities) by providing a framework in which to trade; the latter focuses on the factor markets (i.e., for land, labor, and capital) by determining the relative mobility of resources and therefore the resulting distribution of power within the markets. To overlook the latter is to overlook crucial processes through which capitalism actively evolves over time; for instance, absent the decision to reallocate the legal right to land ownership from established parties (e.g., the lords and the clergy) to a wider range of individuals, political, social and economic power would remain in the hands of a few, feudalism would persist indefinitely, and modern capitalism might never have emerged, a history I will discuss further in Chap. 5. Focusing on trade misses the importance of the production paradigm in developing the factor markets and thus in capitalism itself. Moreover, it misses the role of human agents, specifically political actors, in the emergence and ongoing evolution of capitalism.

As advanced as North's work is, relative to neoclassical economics, he joins Friedman in focusing more on trade than on production, more on the product markets than on the factor markets, and more on markets and their supporting institutions than on politics—and thus the human agency—shaping them. According to North, "The central issue of economic history and of economic development is to account for the evolution of political and economic institutions that create an economic environment that induces increasing productivity."[14] While true, accounting for the evolution of the institutions that enhance productivity takes one into the realm of political science, where the capacities of governments are in turn influenced by political institutions that are quite simply outside of the purview of organized economics.

In a later work, North does express greater awareness of the agency of the political realm in shaping the economic realm, specifically in terms of shaping property rights: "The efficiency of the political market is the key to this issue. If political transaction costs are low and the political actors have accurate models to guide them, then efficient property rights will result. But the high transaction costs of political markets and subjective perceptions of the actors more often have resulted in property rights that do not induce economic growth, and the consequent organizations may have no incentive to create more productive economic rules."[15]

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[13]For a good discussion of this, see Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor*.

[14]North, "Institutions," 98.

[15]North, *Institutions, Institutional Change, and Economic Performance*, 52.

In this analysis North still maintains a narrow view of capitalism. He identifies a role for political agency, but circumscribes this agency as one driven by cost-benefit analysis; in other words, political markets exist, but they function as simplistically as Friedman's economic markets and lead to similarly simplistic outcomes of economic growth or decline. Inequalities in economic and political power, as well as their tendency to shape institutions and their outcomes, are completely missing from the picture. North's work thus not only oversimplifies the evolution of institutions that enhance productivity, but also underemphasizes the idea that institutions can induce or reduce inequalities within society. The latter certainly merits attention, if only because excessive inequalities open the way for the empowerment of elites who can use their economic power to subvert legitimate government, especially if it is a nominally democratic government. As de Tocqueville observed more than 150 years ago, most revolutions have been started either by people who wanted to reduce existing inequalities or, at the other extreme, to avoid their reduction.[16] Economic governance thus inevitably involves political institutions as well as political objectives, and capitalism cannot be reduced to the impersonal science of market forces alone.

Thus, to view capitalism as a system of governance, we must follow North's progress beyond Friedman to recognize the decisive role of institutions in shaping the markets, equilibrium or no. But we must then go further to recognize that the evolution of these institutions is in turn built upon human agency, as the political system determines the rights, responsibilities, and resulting powers of individuals and institutions within the economic system over time. We must recognize that some of the essential coordinating processes that influence economic development lie beyond the traditional bounds of economic analysis, beyond the narrow, market-focused scope of neoclassical economics, and beyond even the broader scope of North and his colleagues in institutional economics. The study of capitalism is a study not of economics but rather of *political economy*, an interdisciplinary form of study that prevailed until the emergence of neoclassical economics at the turn of the 20th century and to which we must return today, if we are to truly understand and thereby shape our capitalist system of governance. Such is the motive behind my own conception of capitalism, discussed below.

My Conception of Capitalism

My conception of capitalism is an attempt to address the above oversights in Friedman, North, and their colleagues' theories of capitalism. In conceiving capitalism to be a system of governance, I mean to move beyond neoclassical theory, where markets spontaneously coordinate the activities of economic actors through the price mechanism, to the broader form of analysis of political economy. Where North adds a second level of analysis involving the institutions that shape those

[16] Alexis de Tocqueville, *Democracy in America*, vol. 2 (New York: Harper & Row, 1966), 611.

markets with incentives and constraints, I am adding a third level where a political authority governs how those incentives are designed, shaped through a political process, and eventually administered.

My primary claim is that the visible hand of human agents in government is necessarily involved in establishing and maintaining the institutional structures that in turn shape the markets in which the invisible hand of the pricing mechanism operates. Capitalism can neither emerge nor develop without such constant human intervention. While it may be useful to speak of the emergence of capitalism by way of an "evolution" of human institutions, this evolution cannot be accounted for through the study of natural forces, as in biological evolution. Unlike biological systems, which evolve through natural selection among random varieties, capitalist systems have been driven by human purposes from their very origins. Furthermore, they have the capability of purposive adaptation; they can take a step backwards in order to advance two steps forward at a later time, which cannot normally be achieved by a biological system. Such purposive adaptation implies a strategy, even if an imperfect or incoherent one, on the part of government, which in turn implies the existence of varieties of economic governance and thus varieties of capitalism.[17]

To put it simply yet clearly: Friedman conceives of capitalism as a one-level system for achieving economic coordination (i.e., economic markets), North conceives of it as a two-level system (i.e., economic markets embedded in institutions), and I conceive of it as a three-level system (i.e., economic markets embedded in institutions governed by a political authority accountable to political markets).

Capitalism Is an Indirect System of Governance

My historical and theoretical studies of capitalism led me to my own definition of capitalism as an indirect, three-level system of governance. I begin here by explaining its indirect nature. Capitalism is an indirect system of governance because the economic actors are governed by laws and rules that set conditions for acceptable behavior; it contrasts with two historical and two contemporary systems of governance for economic relationships. The first two are slavery and feudalism, both of which have become largely or completely obsolete, at least at the societal level. Slavery has a long history, was important as recently as the mid-19th century, and will figure later in Chap. 7's story of the early development of the western hemisphere. Feudalism, though largely extinct, has had a much more important role in economic history; indeed, capitalism emerged from centuries of feudalism almost everywhere, and in Europe in the period 1400–1800, as we will discuss in Chaps. 5–7. The US experience of launching capitalism from what the settlers thought was a clean slate was exceptional in this regard.

[17]See, for example, Peter Hall and David Soskice, eds., *Varieties of Capitalism* (Oxford: Oxford University Press, 2000).

I focus less on these first two systems here, as they are rarely found today and will emerge later in my discussions of the origins of capitalism. Both slavery and feudalism preclude an essential ingredient of capitalism, i.e., relatively free factor markets, as I suggested above and will briefly explain here. The defining institutions of capitalism tend to be in its factor markets (e.g., land, labor, and capital) and not in its product markets (e.g., fruits and vegetables, textiles, and other traditional tradable commodities); the former are more deeply embedded in the political and social systems of a society and ultimately define how resources may and may not be used, not to mention by whom. More simply, products can be traded back and forth between anyone, even peasants in a feudal system, but the sale of land, the contracting of labor, and the lending of capital require a social system in which these factors are not fixed, as in feudalism or slavery. Some experts have referred to systems as capitalist because of the existence of small amounts of "free trade" side by side with factor markets characterized by slavery, forced labor, or a feudal system where capital was not officially permitted to earn a return. I disagree; where forced labor or slavery are general conditions applying to a majority of the population, this does not seem to me to meet the test of free markets that is essential to capitalism, no matter how much trade or entrepreneurial activity is engaged in by an elite few.

Though often left unsaid, and indeed unexamined, the freedoms of capitalism imply opportunities for personal growth and development; a system of forced labor or one with little or no educational opportunity for much of the population denies the substance of those freedoms to that fraction of its population. Historically speaking, those freedoms have been achieved primarily by overthrowing the prevailing social system; almost all "advanced" societies circa 1500 were governed through feudal systems, and the achievement of factor markets in these societies required a decisive break from feudal control of land and labor (e.g., revolution in England in 1689, in France in 1789, and, later, hostile takeover in Germany and Italy by French troops). The crucial step in achieving capitalism in almost all countries throughout history has been the overthrow of the institutions of slavery and/or feudalism, liberating the factor markets for land and labor.[18]

The second two contrasting systems of economic governance still exist today. The first is a largely if not completely informal economic system where self-sufficiency, perhaps among family units, is practiced with only a modest degree of specialization or trade. In such cases, the rules for property ownership and trade are informal, and they depend upon a family or tribe as a coercive authority to enforce them. Historically, this latter form of organization characterized many indigenous peoples, and it still has scattered exemplars today. The second

[18]The achievement of capitalism in Australia, New Zealand, and the US was arguably exceptional because feudalism never was strongly entrenched in these countries, and this was only slightly less true in Canada. Canada started out in the feudal land holding pattern along the St. Lawrence River, but most of its territory was developed under British laws following British takeover early in the 18th century. For much the same reason these same countries were also early to achieve democracy.

contemporary alternative is based upon direct control of human and other resources through a hierarchy backed by the coercive powers of a state, as in the former Soviet Union. It is against this alternative, one that has arguably been more prevalent since 1900 or so than the aforementioned three, that I most frequently contrast my conception of capitalism as an indirect system of governance. I refer to this statist alternative as a *direct* system of governance through a hierarchy, where governance can be by command and control. Likewise, I refer to my own conception of capitalism as an *indirect* system of governance, where governance occurs not by political authority itself but rather through the rules and institutions it shapes.

Table 2.1 lays out the three contemporary economic systems, two in which economic coordination takes place under the auspices of the state and a third where such coordination is entirely private and informal. The figure also identifies different forms of intervention and coordination. Adam Smith's invisible hand is one of the formal coordinating mechanisms in a capitalist economy, but only one of the three. I will explain the other two mechanisms shortly.

Milton Friedman, in his own work, and particularly in *Capitalism and Freedom*, correctly recognizes the direct economic systems in column one (the example of

Table 2.1 Three systems for organizing and coordinating economic activity

	Organizing authority		
Economic institutions	The state		Private parties
Forms of state intervention	Direct	Indirect	No formal role for the state
Planning	Central plan with mandatory targets	Framework of laws and regulations establish a context for decentralized decision making	Decentralized decision making based on informal rules and understandings
Mechanisms for coordination	Central plan plus state ownership and direction of enterprise	1. Pricing mechanism 2. Market frameworks 3. Corporate strategies	Informal pricing mechanism for informal commerce
Enforcement	Enforcement of decisions through state bureaucracies, e.g., line ministries and central bank	Regulatory terms and conditions enforced by the coercive powers of the state (e.g., regulators and courts)	No legitimate coercive enforcement mechanism
Economic System	Controlled economy	Capitalism	Unregulated trade
Examples	The former Soviet Union	The United States	An informal market

Source: Bruce R. Scott

which is the former Soviet Union), while, in my view, he conflates columns two (ex: the United States) and three (ex: an informal market) of Table 2.1 and declares them to constitute capitalism. Friedman identifies capitalism, i.e., competitive capitalism, as "The kind of economic organization that provides economic freedom directly . . . [and] also promotes political freedom because it separates economic power from political power and in this way enables the one to offset the other."[19] Friedman thus explicitly removes government as much as possible from his competitive capitalism, claiming that in this economic system, "an impersonal market separates economic activities from political views."[20] Government's role is to "determine, arbitrate, and enforce the rules of the game" of capitalism and not to directly participate in it.[21] And even in this supporting role, government is to merely codify custom, or that which has already been agreed on: "most of the general conditions [of capitalism] are the unintended outcome of custom, accepted unthinkingly."[22] What Friedman is describing is, therefore, not capitalism but rather the informal system of column three.

Friedman further diverges from Table 2.1 by claiming that "there are only two ways of coordinating the economic activities of millions," and not three. He identifies the first as "central direction involving the use of coercion—the technique of the army and of the modern totalitarian state." This form of coordination corresponds to column one of Table 2.1. Its alternative, according to Friedman, is "voluntary co-operation of individuals—the technique of the market place," i.e., his notion of capitalism or column three of Table 2.1.[23]

Friedman's capitalism is not capitalism but rather an informal market and, thus, a scenario that rarely exists today in the more developed economies. Consider his elaboration on the coordinating force key to his capitalism, i.e., voluntary cooperation:

> The possibility of co-ordination through voluntary co-operation rests on the elementary—yet frequently denied—proposition that both parties to an economic transaction benefit from it, *provided the transaction is bilaterally voluntary and informed*. Exchange can therefore bring about co-ordination without coercion. A working model of a society organized through voluntary exchange is a *free private enterprise exchange economy*—what we have been calling competitive capitalism.[24]

In this key paragraph Friedman seems to refute his prior claim that government's role is to "determine, arbitrate, and enforce the rules of the game," all of which implies the right of a government to use coercive power and thereby

[19] Friedman, *Capitalism and Freedom*, 9.
[20] Ibid., 21.
[21] Ibid., 27.
[22] Ibid., 25.
[23] Ibid., 13.
[24] Ibid. Italics original.

place conditions upon the freedom of economic actors. Voluntary transactions, or trade, are indeed a crucial component of capitalism, but like competitive play in an organized sport (an analogy to which I will return below), the economic actors in a capitalist system enjoy freedoms that are conditional, i.e., they are free to act only so long as they remain within the parameters of the laws and regulations that define the various markets of capitalism. If neither party can count on the state to use its coercive power to protect the respective parties from failures by the other party to deliver the goods or services or payments due on time and in the conditions agreed to, then this commerce is not capitalism. Instead it belongs in column three.

The purely private means of coordination that Friedman refers to, via a price mechanism and interpersonal trust between the participants, is not, strictly speaking, even part of a capitalist system. Instead these relationships define the informal economy; it is a grey or black market where there are no formal standards to define what is being traded or who has what rights and responsibilities before or after the transaction. It can exist alongside a capitalist system, but as anyone from a developing country or one recovering from civil war knows, such a lack of formality reduces the efficiency and transparency of market transactions. Imagine, for example, how much business would be transacted by credit cards if there were no security in their use and no recourse in the event that a card were lost or stolen. US federal law currently requires the issuer to be responsible for all such costs in excess of $50, and the issuer can recover such charges by spreading a small insurance cost across all users. That compulsory responsibility for the issuer is part of the genius of capitalism; the issuer is much better placed than the user to stop such losses rapidly and to eventually collect any damages.

Informal commerce may be said to be "free," but this freedom is not the orderly commerce that is the hallmark of capitalism. Instead it defines the uncertainty and disorder of a free-for-all. The farm stand selling fresh vegetables to a random passerby may seem like a good model of informal, voluntary capitalism, but if it does business without a zoning permit and periodic visits from the health authorities it is most likely an illegal operation that may also be a source of unsafe produce. Moreover, absent rules enforced by a vigilant political authority, it may conduct business in a way unsafe to not only private but public goods, as in polluting the environment. This issue of public goods or, more simply, the common, will be addressed again later in the chapter.

In contrast to Friedman, I conceive of capitalism as the indirect system described in column 2 of Table 2.1 and simplified in Fig. 2.1. All formal markets are governed by laws and regulations, and these laws and regulations must be backed by the coercive powers of a legitimate political authority (typically its state bureaucracy) if they are to constitute effective frameworks for market transactions. Coordination within this formalized system is achieved by three mechanisms, the first of which is the price mechanism. The second is the whole institutional framework that underpins these markets; it is the administrative apparatus through which the visible hand of government translates estimated societal costs and benefits into various rights, taxes, and subsidies in order to approximate true social costs for each particular society.

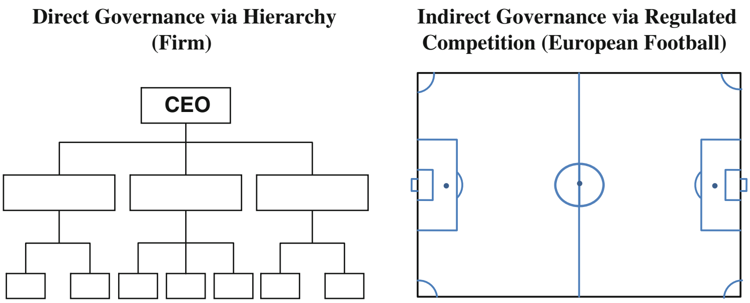

Fig. 2.1 The direct governance of the firm and the indirect governance of the field. Source: Bruce R. Scott

The third mechanism is private, but it is not based upon voluntary actions by consenting adults like informal markets are; it depends instead upon the strategies of firms, especially large firms, and upon hierarchical control exercised within those firms, as I will explain in the appendix.

Capitalist governance thus stretches beyond the bounds of economic markets to include the institutional foundations that both underpin and shape those markets. It is neither an informal nor a direct system of governance, but rather an *indirect* system of governance. As the informal or tribal system does not exist on any large scale today, contrary to the implications of Friedman's assertions, the most relevant alternative to capitalism is that of direct governance, and it is that to which I compare it from now on. The contrast between direct and indirect governance can be highlighted by contrasting top-down governance through hierarchy within a firm and indirect governance through rules and regulations as practiced in organized team sports, as shown in Fig. 2.1.

Capitalism Is Analogous to Organized Sports

The sporting analogy introduced above proves useful as I go further in explaining my conception of capitalism and contrasting it with that of others, such as Friedman, and I will accordingly refer to it often. As shown in Fig. 2.1, in capitalism as in organized sports, the institutional context shapes but does not directly control the behavior of the actors. To continue with the sporting analogy, if the institutions of a football contest mandate a ball that is round and prohibit the use of the hands except in a few tightly defined circumstances, then the players can be expected to compete like European footballers. Put those same players in a game with an oblong ball and permission to use their hands to throw and catch it, and they are apt to play like American, Australian, or Canadian footballers. The institutional context of organized sports shapes the behavior of athletes, but it does not directly control their behavior, and this parallels the governance of capitalism.

Capitalism Is a Three-Level System of Governance

All organized sports can be understood as three-level systems, as suggested in Fig. 2.2. The first level is the game itself, in which athletes compete with one another, whether as individuals or as teams. This competition is usually the focus of audience attention; we are concerned to see who wins or loses as well as how the game is played. Organized sports are not played in back alleys or out in the tall weeds, nor at random times among random assortments of athletes. Rather, the actual competition usually unfolds in carefully marked-out areas, at specific times, and under the supervision of a set of referees. The use of an explicit setting and set of rules for sports parallel capitalism's nascent beginnings in the late middle ages, when it was confined to specifically designated market locations and market days and was often carried out according to a prescribed set of rules, often under the direct supervision of duly chartered guilds of registered tradesmen. Likewise, unorganized sports parallel an informal economy, or column 3 of Table 2.1.

In organized sports, the players, coaches, and other team personnel comprise the first level of the system; the boundary conditions for such a contest are created and maintained by the administrative and regulatory officials who comprise the second level. More specifically, these agents demarcate and indeed maintain the field, specify the rules of play and the scoring system, and monitor the play. These agents organize and legitimate the competition and ensure that it is carried out on a level playing field, with no unfair advantages permitted.

These institutional foundations (e.g., the officials and the rules they enforce) are in turn created and legitimated by a governing organization comprising the third and final level. This governing organization is a political authority with the power to decide on the rules, i.e., who is eligible to compete, the time and location of the games, and technologies that may be used. In professional sports, the political authority may also have the power to set the terms and conditions for the distribution of certain revenues among participating teams, a power that can be exercised to limit disparities in incomes by team, thus curtailing the relative power of one or

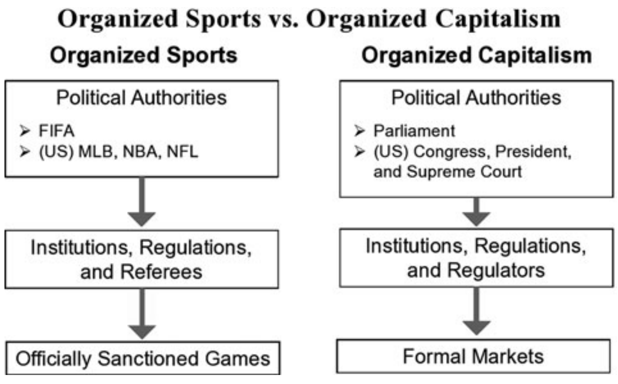

Fig. 2.2 Both organized sports and organized capitalism are three-level systems. (For a discussion of the US Supreme Court's role as a political authority, see Chap. 13.) Source: Bruce R. Scott

a few teams to dominate the sport year after year.[25] For instance, the Olympics are organized as individual sports under the auspices of an umbrella organization, a slight variant from the diagram above. International football is organized in the usual pattern, where the International Federation of Amateur Football, or FIFA as it is known in French, establishes the rules and hires the judges to monitor competition. US professional football is organized under the auspices of the National Football League (NFL) in a similar structure.

Thus I arrive at my conception of a three-level system of governance, in both organized sports and capitalism. Capitalism is an indirect, three-level system of governance, where a political authority permits economic actors to mobilize and employ resources in competition with one another, subject to a set of laws and regulations as defined and enforced by one or more regulatory agencies. The political authority comprises the top (third) level in the system; the regulatory and other institutional foundations provided by that political authority comprise the middle (second) level; and the regulated competition among economic actors in markets comprises the bottom (first) level.

On the first level, firms compete to secure their labor and capital as well as to serve their customers. And, as with sports, individuals and firms mobilize and apply energy to achieve their goals, some following distinctive strategies while others will play it safe with a "me too" strategy. On the second level, the basic institutional foundations, including physical and social infrastructure as well as the individuals and organizations operating them, set the terms for the behavior of the actors on the first level. Physical infrastructure includes, among other things, transportation and communications; social infrastructure includes the educational, public health, and legal systems. Those operating these basic institutional foundations and enforcing their rules are typically agents of the state, including specialized regulators who oversee behavior in certain industries. Examples include those who deal with food and drugs or transportation and those who protect societal resources, such as the physical environment or safety in the workplace. On the third level, a political authority—typically one with specialized functions such as executive, legislative, and judicial branches—actively oversees and shapes the operations of the first two. A set of political institutions connects the political authority to the political markets (e.g., elections, which may be more or less democratic) and eventually to civil society, to which such an authority is ultimately accountable. I will connect the economic and political systems in greater detail in the next chapter.

A Critique of Friedman's Sports Analogy

It is fitting to note that my use of organized sports as an analogy to capitalism is not unique. Specifically, Friedman also employs this analogy, comparing the

[25] In the United States, the National Football League is widely recognized as the most socialistic of the organized sports because the league authorities have the power to distribute the television revenues approximately equally among teams despite the difference in the markets that they directly serve.

"day-to-day activities of people" to the "actions of the participants in a game when they are playing it" and likening the "general customary and legal framework" within which these activities take place to "the rules of the game they play."[26] However, as with his conception of capitalism in general, his analogy contains some significant oversights; he omits any specification of a political process for its governance or any notice of cumulative advantages in capitalism. Instead, he emphasizes the voluntary nature of submission to rules and conditions in both sports and society. While asserting the need for agreement to the rules or conditions, as well as the need for a system of arbitration (e.g., an umpire supplied by a government), Friedman ascribes the source of these rules and conditions to custom or general consensus and claims that "no set of rules can prevail unless most participants most of the time conform to them without external sanctions."[27]

Friedman overlooks the political complexities of the process of establishing and reforming the rules of the game, capitalist or otherwise. According to Friedman, "These are the basic roles of government in a free society: to provide a means whereby we can modify the rules, to mediate differences among us on the meaning of the rules, and to enforce compliance with the rules on the part of those few who would otherwise not play the game."[28] But where do the rules comes from, who do they favor, and how are they modernized? While Friedman maintains that the market of competitive capitalism "separates economic activities from political views," he acknowledges that "the role of government . . . is to do something that the market cannot do for itself, namely, to determine, arbitrate, and enforce the rules of the game."[29] If the rules of capitalism are created and modified by political actors, how can they ever be devoid of political biases?

For Friedman to assert a clear separation between economic and political power is to contradict not only his own theory but also reality; the market frameworks, the laws, are always created by political actors and therefore, to some extent, always contain a political agenda or tilt within them. To say, as Friedman does, that the rules of capitalism are the unintended outcome of custom, formalized through government, makes it sound as though the outcomes are almost as obvious as natural laws where *most* participants *most* of the time conform. Friedman in fact almost asserts as much, stating that in the impersonal markets of competitive capitalism, "no exchange will take place unless both parties do benefit from it."[30]

Friedman's conception of a competitive capitalism where markets are impersonal, apolitical, and unbiased, and where government plays as minimal a role as possible, is not the capitalism that we live today or, arguably, any sort of capitalism that ever existed. It is a conception of an informal economy, something that

[26]Friedman, *Capitalism and Freedom*, 25.

[27]Ibid.

[28]Ibid.

[29]Ibid., 21, 27.

[30]Ibid., 13.

exists only in the world of the fruit-and-vegetable stand or the black market, where exchange is predominantly governed by trust between local participants. To understand capitalism as organized sports in the way that Friedman does is to overlook the essential roles of institutions and government; to use these ideas as a basis for deregulation of a modern economy is to open wide the gates to a free-for-all in the markets. As the many cases of this book will show, and especially the analysis of the transformation of US capitalism in Chap. 13, economic actors, if left "free" to exercise their powers in a so-called free enterprise context, can challenge and even overwhelm government, thereby suborning democracy in favor of oligarchy. The industrial giants of the 19th century US economy grew in terms of employment roughly a thousand-fold during that century, and surely far more than that in terms of the assets and income streams that they controlled. Furthermore these same giant firms took over much of the coordinating function from the markets, as Alfred Chandler pointed out in his justly famous masterpiece *The Visible Hand*. US authorities, judicial as well as political, permitted a vast growth of power in private hands, while reducing the accountability of US firms to those same political and regulatory authorities.

Government is not alone in its capacity to abuse power; given a chance, the private sector can and often will abuse its powers so that markets work for the few and not the many. Governments must restrain and regulate those with private power if they are to fulfill their responsibilities to protect the citizenry, i.e., to supply tolerable law enforcement. In addition, and as discussed further in this chapter, capitalism requires that government play a positive role in providing the public goods for which it is responsible, and without which most people cannot expect to take advantage of the opportunities that capitalism offers. From this enumeration of the essential roles of government, it should be clear that the political realm cannot be cleanly separated from the economic and that any analogy of capitalism with organized sports must therefore take into account the role of governing authorities (e.g., league organizers, referees, and judges).

As a final critique, Friedman's comparison of capitalism with organized sports overlooks the key area where the two in fact differ. Namely, power earned in the economy can be used to influence political decisions and, in this respect, capitalism is quite distinct from and perhaps weaker, as a system, than organized sports. In organized sports, the teams are normally of equal size, much as in the model of atomistic competition. However, in capitalism one firm may be ten times the size of another, or a hundred times, or a thousand. Capitalism can thus support oligarchy, even a corrupt oligarchy, and in such a case it is not the guarantor of the freedoms that Friedman, with his simplistic sporting analogy, claims for it. Those claims cannot be expected to be justified unless civil society is alert to the unequal distribution of power within the system, particularly that of political power. Laws neither make themselves nor enforce themselves. Unless there is demand for enforcement, it will not normally happen. On these issues, Friedman is silent. The issue of power relationships in a capitalist economy is key to this book, and thus I will take the remainder of this chapter and the next two to better establish the scope and interplay of the linkages between economic and political power.

Political Authority Shapes Capitalism with Visible Human Agency

The distinguishing contribution of my theory of capitalism is the third level of political authority. Recognizing the role of human agents, those within government in particular, is central to the theory and case studies of this book as well as to understanding the realities of capitalist societies.

As the theories of North but especially of Friedman demonstrate, capitalism is often defined without a notion of human agency let alone government. Most commonly, capitalism is understood in Friedman-like terms as the process by which economic markets utilize the "invisible hand" of the price mechanism to spontaneously coordinate supply and demand between actors competing for particular goods and services. However, in practice, the visible hands of human agents are implicated in the process, guiding the invisible hand of the pricing mechanism. Specifically, the invisible hand can only align individual and societal priorities if the institutional foundations of capitalism have *shaped* those markets so that individual costs and benefits reflect those of society rather than those of an unruly mob or powerful elites. The pricing mechanism cannot come close to achieving an optimal coordinating role absent the effective work of the visible hand of government, often through legislative processes such as a parliament.[31]

Followers of Friedman tend to not only overlook but also actively reject this role of government in the capitalist system. According to them, informed, voluntary, and bilateral transactions are the essence of a self-regulating capitalist system and therefore that system can and must be free from governmental coercion. But in reality, coercion is to be found in most capitalist markets; large firms coerce those that are smaller, a patent holder enjoys market power, an employer typically authorizes only one employee to make a job offer to a prospective employee, and employees may or may not organize to bargain in a similar format. The regulatory institutions deal routinely with various forms of coercion; it is the rule and not the exception. Likewise, they themselves employ coercion to create the freedoms of a capitalist system. Quite unlike Friedman's theory of the almost absolute freedom of economic actors, the reality of a capitalist system demonstrates that the so-called freedom of economic actors is almost always *conditional*, and conditional both on the voluntary actions of a trading partner and also on the rules and regulations established by the state. Successful capitalism depends not only upon the state granting power to private actors to enter, compete in, and exit from markets, but also upon the state restraining private actors so that they do not abuse this power. In a capitalist system, the participation of private economic actors is conditional on their agreement to follow the rules set and enforced by the state. Capitalist freedom is thereby conditional, and political authority shapes the conditions to ensure fair play among competitors who have very different powers.

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[31] The emergence of capitalism does not require democracy; in fact, it appears to be a necessary precondition for the latter.

Thus, when we look at the reality of capitalist systems, we see that while ostensibly free competition in economic markets is an essential and utterly distinctive feature of capitalism, it represents only part of a capitalist system and not the totality. Yes, capitalism relies upon the concept of competition to energize human actors and on prices to coordinate their actions. But it also relies on a notion of regulation to limit or constrain the behavioral practices in which economic actors are permitted to engage. For instance, every transaction is subject to a process of authentication, a process necessary in the event of a dispute of what was agreed to. However, regulation and authentication of the terms of a trade cannot be accomplished by the economic actors alone; their isolated, individualistic positions in economic markets prevent them from effectively, not to mention legitimately, adjudicating differences or enforcing settlements. A higher-level entity with legitimate authority and coercive power is needed, i.e., a political authority. Barter can take place in a back alley, with no authentication of the transaction and no records; in contrast, organized capitalism requires the auspices of a political authority to create and legitimate one or more regulatory authorities to authenticate transactions, adjudicate differences, and coerce enforcement when necessary. As a result, markets are embedded in, or underpinned by, institutions that are in turn parts of systems of laws, public administration, and, ultimately, government. The design and shaping of those institutions, the monitoring of the behavior of the economic actors within them, and the application of coercive force to demand remedial behavior if and when needed are all crucial functions of the political authority within any system of capitalist governance.

Recognizing a strong role of government in the shaping of institutions that in turn shape economies has in fact proven crucial to economic development. For instance, the timely modernization of capitalist institutions in Europe was an important contributing factor to the ability of certain states to finance military forces to maintain independence and ultimately survive the nearly continuous warfare of the region in the critical formative centuries. Countries such as England and the Netherlands, which had overthrown arbitrary rule by divine right, could raise money more easily and at much lower rates of interest than those ruled by absolute monarchies, as in France and Spain; the former were thus able to hire mercenaries to protect themselves from repeated attempts of hostile takeover by the latter. In such circumstances, preservation of autonomy came ahead of efficiency as a political and economic goal, and achievement of this goal required maintaining an active ability to mobilize resources rather than passively accepting resource mobilization as beyond societal control.

As the above example demonstrates, economic governance implies far more than facilitation of equilibria in markets; it implies that markets are achieving the purposes for which they were designed, which initially included helping to finance warfare. Mercantilist policies were not necessarily the folly that they are sometimes supposed to have been; they were a means to mobilize economic power to help maintain independence. Whether wise or not, states had policies other than promoting consumer welfare, and they used human agency in the design of economic institutions to pursue them, actively directing the markets towards their desired equilibria.

While market-based coordination has proven a very desirable and efficient system much of the time, equilibrium itself is not necessarily a sufficient indicator of appropriate governance, Economic markets can achieve undesirable equilibria which yield extraordinarily distorted circumstances. For example, they can even achieve so-called equilibrium during a crisis, as the system implodes, as in the cases of the Great Depression and of the more recent chaos following the bankruptcy of Lehman Brothers in 2008, which I elaborate on in the Epilogue. Indeed, as another example, the US mortgage markets were able to achieve remarkable efficiencies as well as equilibria from the mid-1980s onward, thanks to new financial engineering. However, these equilibria were accompanied by—or rather, supported by—distorted circumstances. These included the inflation of a bubble, as both consumers and lenders took on reckless levels of leverage in the expectation of continuously rising prices, and as US financial leverage relative to GDP almost tripled between 1980 and 2006, making all such transactions far more risky. The distortions seemed to have escaped the attention of US regulators as well as the attention of the economic actors themselves, who left them unchecked until the emergence of the credit crisis in August 2007, a crisis that gradually became a full-fledged, worldwide economic crisis in 2008. All through this process, the invisible hand of market forces struggled to maintain equilibria in supply and demand across thousands or likely millions of economic actors in more than one hundred countries and currencies. But the invisible hand could not judge the adequacy of the design of the market frameworks in which transactions between those actors took place, and, as is now clear, many and perhaps most of the economic actors and regulators proved equally inept at judging the adequacy of the system, or even unwilling to engage in such judgment, all the while believing that any outcome of a so-called free market system would be acceptable if not ideal. To ignore the fundamental import of the regulatory role of a political authority in such circumstances is to substitute ideology for analysis and to invite chaos, as the results of their inaction now demonstrates.

The basic premise of this book is that capitalism is not simply a system of economic relationships that are coordinated through the invisible hand of the pricing mechanism in markets; it is also, and perhaps more importantly, a system of governance that requires, first, the articulation of a political vision to guide the design of market frameworks that will work toward achievement of societal goals and, second, the mobilization of political power to legitimate the vision with the electorate and then to implement those frameworks so as to shape the markets, to monitor the actions of human agents who ensure that the competitors follow the rules, and, crucially, to modify these institutional frameworks as needed to ensure that the markets yield results that are considered to be broadly in the interests of society. No invisible hand can create the frameworks, monitor them, or design and implement modifications to correct their unwanted side effects. The essential institutions of capitalism cannot develop along with the needs of society absent the informed and capable input of human agents, such as those empowered through a government. Gabriel Almond, as mentioned in the Introduction, has stated these basic ideas of capitalist governance: "The economy and the polity are the main problem solving mechanisms of human society. They each have their distinctive 'goods' or ends. They necessarily interact with each other and transform each other in the process."[32] As problem solving mechanisms, they require human agency within them. This essential human role means that capitalism is a mix of sociology, administration, politics, economics, and law, and that any theory of capitalism must include not only an economic level but also a political level, what I call here the third level of political authority.

Political Authority Plays Both Administrative and Entrepreneurial Roles in Shaping Capitalism

In sports, as indeed in capitalism, the level of the political authority encompasses two distinct roles: one administrative, in maintaining the existing system with its approved teams, rules, and existing organization for the monitoring and enforcement of the rules, and the second entrepreneurial, in mobilizing power to win the needed votes in the legislature in order to admit new teams, change the locations or timing of competition, change the rules and regulations, and/or change the distribution of revenues. Every time a political authority wishes to enact change, its leaders must mobilize enough power to overcome the forces that wish to protect the status quo. In organized sports the political leaders may have gained their position of power through purchasing a league franchise to own a professional team. While they typically operate through political bodies (e.g., an executive and a legislature), the members of the league's legislature own their seats and typically are not accountable to an independent electorate. In addition, the entrepreneurial aspect of teams exercising political power in organized sports is very different from that of firms exercising political power in democratic capitalism, insofar as the political authorities, for most organized sports, operate under a grant of immunity from antitrust laws, which allows them to govern their league through face to face consultation much like the officials who govern a state. Teams in a sports league can sit together as a legislature to revise the rules of play, admit a new team to the league, and even to legislate a split of revenues, if they wish, e.g., television revenues. Firms can mobilize lobbying power through trade associations but are not usually permitted to control entry to their industry or to split revenues let alone rig prices.

Given this comparison, consider the dual role of political authority in a capitalist system. The continued success of capitalist systems depends upon the periodic modernization of the legal and regulatory frameworks as indicated by changing market conditions and societal priorities. Government therefore must play the two distinct roles of administrator and entrepreneur. In the short-term, quasi-static perspective, government and its agents administer the existing institutions, both physical and social. In a longer term perspective government must have the capacity to modernize these institutions as conditions indicate. This second role requires foresight to recognize needs, and entrepreneurial skills to mobilize enough power to effect

[32] Almond, "Capitalism and Democracy," 467.

the needed changes through a legislature. Given its added complexity of intentional change (as opposed to simple maintenance of the status quo, in the administrative function), this second role requires further elaboration.

Successful capitalism requires a system of governance that is built from the premise that there is no one solution or fixed set of relationships that is best for all times and circumstances. The system of governance must be able to manage its own capabilities and legitimacy in such a way that it can be efficient in meeting its responsibilities in the short run, while evolving as circumstances change, including as societal priorities change, so that it can cope effectively with a changing context. This means that government must be entrepreneurial; identifying changes that need to be made and mobilizing the political power to effect such change in legitimate ways in a timely fashion.

Adam Smith had one of the great insights of all time when he recognized that the invisible hand of the pricing mechanism could coordinate economic transactions in ways that spontaneously served the public interest. But when he opined that "Little else is required to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes and a tolerable administration of justice,"[33] he was overlooking the entrepreneurial role of government in the continuous process of modernizing the institutions of capitalism. Can we honestly say that the "tolerable administration" of laws and institutions is remotely adequate to meet the entrepreneurial responsibilities of government in the appropriate shaping and periodic modernization of laws and institutions in a complex society? Is the formulation of patent laws to protect inventors as well as investors and consumers a matter of tolerable administration? Is the development of food and drug regulations to protect patients and to provide due process for speeding new products to market any less a matter of genius than how to price automobiles, promote the sales of soup, or to educate consumers to new varieties of hair spray or deodorant?

Smith had the genius to recognize that markets could coordinate the actions of disparate actors in ways that might be superior to explicit bureaucratic planning (like that attempted in France under Colbert) as implied in his famous passage introducing the invisible hand: "As every individual . . . endeavours . . . to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of greatest value; every individual labours to render the annual revenue of society as great as he can. [While] he intends only his own gain . . . he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."[34] Smith did not claim that markets are *always* right, but he did imply that they were right in this and "many other cases." Are there examples where they can coordinate the actions of many buyers and sellers in ways that are not in society's best interests?

Consider a real estate market in which housing prices are rising, down payments on mortgages are unregulated, and real interest rates are zero or even negative; such

[33] Quoted in Gregory Mankiw, "Repeat After Me," *The Wall Street Journal*, January 3, 2006.
[34] Adam Smith, *The Wealth of Nations* (Oxford: Oxford University Press, 1998), 291–292.

a scenario occurred in the US in 2005–2007, under the watchful eyes of a Federal Reserve that seemed certain that the markets would sort things out without added regulation. As is now evident, individual decisions in this market, characterized by rising assets prices and easy credit, were apt to involve cumulative speculation and the creation of a bubble. Smith's great insight implicitly assumes that the market frameworks take appropriate account of all societal costs and benefits. How can they take account of a speculative bubble that was facilitated if not caused by reflationary monetary policies managed by the Federal Reserve Bank, other than to wait for the bust? This would seem to be a situation that calls for human agency, in this case from the same Federal Reserve Bank that helped to facilitate the growth of the bubble in the first place. Moreover, it calls for agency on the part of political authority and its regulators taking an entrepreneurial, active role in economic affairs.

Choosing (or not choosing) to adapt to a changing context by in turn changing the institutions and market frameworks of a capitalist system implies not only political agency in promoting general social interests, as above, but also political agency in economic development. This returns us to the notion of the production paradigm of capitalism, introduced briefly above. Capitalist development is built from profit opportunities for investment in new technologies and markets, in a context where the opportunities induce increased supply and therefore competitive pressures that generate a Darwinian selection process which weeds-out ineffective uses of societal resources. In order to facilitate such investment, capitalism—via the level of political authority—permits, by allocated legal rights and responsibilities, the existence of different forms of organizations that can exercise differing powers and accept differing risks. For example, governments can permit the chartering of joint stock companies as a legal vehicle for the mobilization of capital, companies that could have a life independent of their founders. Historically this was a huge departure from the prevailing partnership form, which, in some countries, had to be reconstituted whenever a partner died or retired. Governments can also distribute risks in different ways among various economic actors through the institutional frameworks that it creates and legitimates, while at the same time allowing the economic actors themselves to decide how to share the risks and the rewards of economic transactions within those frameworks. For example, the institution of limited liability for shareholders shifts some of the risks of failure from shareholders to creditors, thereby making it easier for entrepreneurs to raise risk capital, a key consideration in promoting economic development. Not least, the modern corporation has the power to solicit private investment on terms where it need never return the money to the investor; the latter can recover part or all of his funds only by vote of the board of directors to pay a dividend or repurchase shares or by finding a third party to purchase his shares at the going price. In permitting such power to mobilize and lock up capital, governments may entrust great power to private parties in the hope that the firms will use this power in ways that contribute to the general economic development of their respective societies, as well as those societies' general socioeconomic well being, a subject that I return to in Chap. 13.

Finally, and on a more macro-level, recognizing an entrepreneurial role for government not only implies recognizing that there is agency on the part of government, but also implies recognizing that there can be a number of varieties of capitalism. The varieties reflect political choices that in turn reflect societal preferences. Capitalism is based upon a generic concept of indirect governance, but there can be different societal preferences that affect the outcomes towards which government indirectly shapes various markets. For example, a societal choice to prohibit collective bargaining, as many societies have done in their early development, is implicitly a strategy to favor capital over labor, at least until such time as the society has become more prosperous. Likewise, a societal choice to prohibit one firm from buying shares in another is implicitly a strategy to try to build a society that has few large centers of private economic power. The US was such a society until the 1880s, when New Jersey's legislature authorized such purchases by firms domiciled in New Jersey. Perhaps the most significant of these societal choices, enforced (and at times distorted) by government, is how to handle the public goods or common resources of society, and it is the topic to which I now turn below.

Capitalism Is a System of Governance for Public, Common Goods as Well as Private Property

So far, our discussion of capitalism has generally focused on private goods and actors. But capitalism is a system of governance for public goods as well, from the environment, to a system of defense, to the law, to the institutions of capitalism and democracy themselves. Collectively, these tangible and intangible resources can be understood as the common property of society, or as "the common" for short.

Any such common is not likely to survive without government recognition and support. Specifically, in the informal, voluntary situation of Table 2.1, column 3, none of the parties would be in any way obliged to pay their fair share of the costs for the use of the common institutions and resources provided by society through government. They would be free to refuse to pay taxes while despoiling the commons, much as the chemical, oil and steel companies did when using the rivers as sewers early in the 20th century. By the same token, a druggist could sell ineffective or indeed dangerous drugs, such as opium or poisons, and an auto manufacturer could sell "lemons," without fear of customer recourse. This is precisely where capitalism (Table 2.1, column 2) achieves huge gains in transparency and effectiveness compared to a less formal if superficially freer system; simply put, a legitimate political authority employing coercive force indirectly through politico-economic institutions ensures that such abuse is limited or perhaps non-existent.

To understand the importance of regulating common goods and particularly the commercial common of capitalist institutions in general, consider the general contrast between an unregulated system and a regulated one (e.g., Table 2.1 columns 3 and 2, respectively) in history. The traditional common was a pasture where a number of farmers or shepherds could share the right to graze their animals, and it had little by way of a formal structure of governance. Absent a political authority to ensure such governance, it was difficult to get the economic actors to limit their usage of the common and even more difficult to get them to accept their fair share of the responsibilities for its maintenance, let alone its improvement. Thus, an inadequately regulated agricultural common could be abused by some of the actors, for example by allowing their animals to over-graze and damage the land to the disadvantage of all of the economic actors, while the lack of a system for improvement could limit any gains in productivity from this resource.

As an indirect form of governance, capitalism creates a somewhat similar common, i.e., the commercial common, where many actors have rights to compete for access to a set of resources and also for the right to sell into a set of markets, all in a context where other actors have similar rights and responsibilities. However, this commercial common has a different history than that of the traditional common, having its origins in a governance system for a much less tangible resource, the market frameworks themselves. Formalization of rules was crucial to the development of this common resource, which might initially entail little more than providing a legitimate source of authority to enforce a set of rules for the trade of goods and services, as already agreed upon by the economic actors themselves. Over time, this commercial common gradually and naturally took on a physical as well as intangible reality as it became important to have roads for travel, designated places for trade, physical protection of the economic actors from thieves, perhaps including unscrupulous tax collectors, and a legal process for adjudicating disputes.[35] However, this commercial common became something quite different when it was extended from the product markets to the factor markets, i.e., the markets for land, labor, technologies and capital.

As suggested earlier in this chapter, the deepening of the commercial common to include the factor markets typically required dramatic changes in power relationships, for example to free serfs from their feudal obligations and allow them instead to work for wages. The same was true for freeing land from feudal contractual obligations, and for permission to amass power through legal vehicles such as firms. Such deepening of the commercial commons to include the factor markets generally required violent change, through conquest or revolution. As a result, it did not happen gradually the world over but rather in some locations centuries before others, a situation that I explore in Chap. 5. The experiences of North America and South America in the period 1500–1800 are a particular contrast, and I explore them in Chaps. 6 and 7.

As the commercial common has been established in different regions over history, its regulation has been a critical issue. Prior to the advent of long distance trade, circa 1500, people all over the world were able to manage their local physical commons because it was small enough for the actors to see the damage that resulted from over-hunting or over-grazing. These actors would then govern themselves accordingly and maintain a stable system whose output was limited. Opening

[35]Garrett Hardin, an eminent biologist, wrote a famous paper on The Tragedy of the Commons, only to recognize later that the tragedy came not from the concept of the common per se but from the lack of effective regulation in how it was used, maintained, and developed through time. See Garrett Hardin, "The Tragedy of the Commons," *Science* 162, no. 3859 (December 1968): 1243–1248.

relatively isolated communities and markets to trade and specialization led to the destruction of many such commons and to a loss of social cohesion in those smaller, more rustic communities. A similar problem remains, albeit on a much larger scale. Successful globalization depends upon successful regulation of a global common, including successful regulation of atmospheric pollutants and of the harvesting of marine life. While excessive regulation has stifled many economies for long periods, inadequate regulation is also a threat to effective decentralized decision making throughout the global common. Abuse of the common is an ever-present temptation that goes with economic freedom. Effective use of a commercial common, as well as its effective protection from abuse, depends upon the maintenance of an effective system of economic governance, and for all practical purposes today that means governance through a capitalist system headed by a legitimate political authority.

Of course, the political authority regulating the common could permit abuse, either passively or actively, by the way it chooses to regulate (or not regulate), much as is suggested in the previous discussion of the state's entrepreneurial role. First of all, capitalist systems typically rely on the state to make direct provision of certain public goods, including highways, schools, and law enforcement, while refraining from the temptation to own, operate, or directly control the economic actors. But if the state does become a direct economic actor, for example as the owner of large enterprises, it becomes a player as well as a provider of institutional foundations of the system. This puts state agents in a direct conflict of interest—for example, as a player with regulatory powers, and thus perhaps not be subject to the discipline of the rules it sets. There are times when states may play both roles, as in the case of a national emergency or natural monopoly, but these interventions are best pursued for reasons of state, e.g. national security, and are best if limited in duration. If direct interventions are widespread or last indefinitely, they invite corruption and the distortion of market frameworks for the benefit of the few at the expense of society as a whole. In a second, more passive form of abuse, the government may indirectly contribute to others' abuse by allowing those economic actors with greater economic or political power to influence its own agents and thereby shape the institutions and markets of capitalism to their private advantage. Such indirect abuse (i.e., abuse via private actors), can, in fact, occur legitimately, via an inherently corrupt strategy, as I will discuss below.

Political Authority Shapes the Economic System in Accord with a Strategy, Implicit or Explicit

As explained throughout this chapter, government's primary mode of intervention in a capitalist system is indirect, through the formulation and enforcement of the laws and regulations that guide behavior and through the provision of certain common resources. Nevertheless, the actions of government inevitably imply strategic "tilts" to the various market frameworks; they tilt toward capital or labor, investors or creditors, producers or consumers, and so on. The market frameworks are shaped or tilted by government, and that shaping can be based upon quite different policy priorities, from protecting the status quo to promoting growth and development. These same market frameworks can accept more or less risk as well as more or less tilting for or against particular classes of economic actors (producers or consumers, etc.). Governments specify the responsibilities of the various participants in these transactions (e.g., for the safety and serviceability of the products) as well as the conditions under which they are produced and distributed. In short, political decisions by government inevitably induce the mobilization and/or allocation of societal and economic resources to favor certain interest over others.

For this reason, the actions of government, whether indirect or direct, inevitably imply a strategy, though this strategy is often largely implicit rather than overt. The strategy (or strategies) may broadly affect the economy as a whole or take a more tailored approach to affect a sector or sub-sector. It may not be explicit, optimal, or even coherent, but it will inevitably favor some interests over others. In addition, however broad or narrow its scope and whomever it favors, the strategy is typically created gradually over time rather than as an immediate grand plan, and typically involves the inputs of many people with competing ideas. It may even be impacted indirectly or covertly by actors outside of the official public realm, such as by private interests sending campaign donations to favor one politician or piece of legislation over another in the hopes of promoting their private gain. (Such interaction between the political and economic systems will be addressed in the following section.)

A particular strategy takes effect at the most general level with respect to market frameworks. As the previous section on the commercial common suggested, market frameworks are key to capitalism; their shape and integrity determines the system's shape and integrity. Market frameworks define what property is and what rights belong to its owners. In addition, they define permissible behavior as the economic actors interact with one another, such as prohibiting price fixing but allowing discount pricing, and provide certain elements of the physical and social infrastructure that may be used in common by these actors as foundations for their activities, whether in production or trade. For example, if one is considering bidding for an empty piece of land, the bid price will be influenced by the market framework as well as by the bids of other actors. The market framework spells out what property rights go with the piece of land. Can one build upon it? Can one only build a residential structure, or would a commercial or industrial structure be allowed? Can one build right to the official edge of the lot, or is there a minimum setback? Can one build to any height, with any mass in terms of cubic feet, and with any architectural style? Are subsurface mineral rights included?

The applicable property rights are established by various political authorities and, in the case of the US, most often by local zoning boards. In Europe many of these same rights are established and administered by provincial or even national governments. These rights affect the potential value of the property for all bidders, and the bidding takes place within the framework that is so established; having that framework local or national can therefore make a great difference in terms of the relative power of the competing bidders, a scenario illustrated in the Prologue to this book.

Furthermore, government, at whichever level, also reserves the right to change the frameworks from time to time as societal priorities change.

Government can exercise strategy in its tilting of market frameworks not only with respect to property rights but in the product as well as factor markets. Consider first two examples from the product markets, namely those for gasoline and pharmaceuticals. The significance of differing frameworks is well illustrated by the contrast in prices between these two markets in Europe and the United States, as shown in Fig. 2.3.

The differences in gasoline prices are accounted for largely by differences in excise taxes among the various countries, with the United States levying a much lower tax on gasoline than its European counterparts. These differences derive from the countries' contrasting strategies: The Europeans have used the gasoline tax as a source of general revenues, while the US has from the beginning earmarked gasoline taxes primarily for highway construction and maintenance. Moreover, as a by-product of these differences, the Europeans have relied on gasoline prices to induce more efficient automobiles while the US has, with less success, attempted to reduce gasoline consumption by establishing regulatory standards of fuel economy for various classes of cars and trucks. Thus even when overarching goals may be similar (i.e., enhanced fuel economy), their achievement may differ significantly depending on which strategies are employed to promote them (i.e., a more market-oriented approach by Europe than by the United States).

When it comes to pharmaceuticals the story is roughly the reverse. The facts are stark: The US, virtually alone among developed countries, allows market pricing for drugs while most other developed countries have price controls. This difference in pricing policies by country has led many European pharmaceutical firms to shift important parts of their research activities to the United States, where they have a much better opportunity to recover their research investments. In a sense, then, US

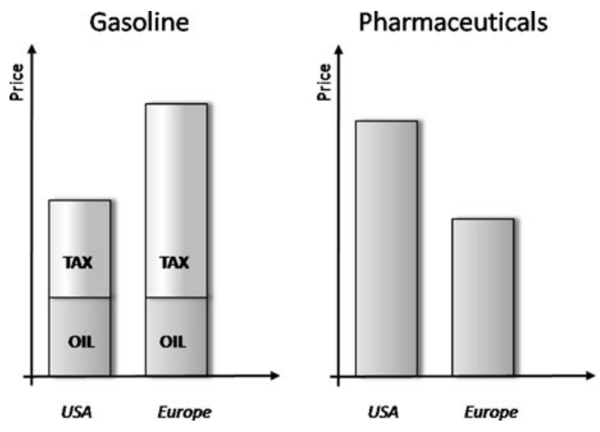

Fig. 2.3 Market frameworks, for instance in the product markets, differ from one country to another. Source: Bruce R. Scott

consumers end up footing much of the bill for pharmaceutical research for the rest of the world. At the same time, the US has developed a health care system where much of the cost is borne by employers. European competitors have an advantage in that their firms do not have comparable health care costs because the latter are mostly borne by their respective governments.

All these distinctions derive from the countries' contrasting strategies and resulting shaping of market frameworks. The United States, with strategies aimed both at promoting research and at privatized health care, has ended up shaping its frameworks to create a market where health care costs are much higher and borne disproportionately by employers. Many European countries, in contrast, have embraced a strategy of limiting health care costs and nationalizing their burden; the effects have thus been quite different than in the US, with pharmaceutical companies moving research abroad and consumers receiving widespread, typically universal and low-cost health care. In this case we again see how different strategies lead to very different market outcomes and thus very different varieties of capitalism.

Perhaps the most striking example of government strategy, in terms of its fundamental importance to modern capitalist systems, is that of government actively encouraging the mobilization of capital. Consider the various legal institutions government must set up to allow an individual versus a corporation to successfully (i.e., safely) invest his or her capital in a project, and even borrow additional money to achieve larger scope or scales. If the project fails, the individual investor is liable for repayment of the loan, while a corporation that has been granted the right of limited liability is in a different and preferred position. The investors in such a corporation can lose their investment if the firm fails, but they are not liable for the bank debts at all, in contrast to the individual above. The creditors can only claim their respective shares of whatever remains of the assets of the firm. By choosing to allocate legal rights in this way, the government has implemented a strategy that distributes risks and rewards among various interests, corporations, individual investors, and creditors. Government is thus necessary not only for enabling the effective existence of important institutions such as "limited liability," "foreclosures," and even "loans," but also for tilting their structure to give certain interests a better deal than others, depending on the circumstances.

What this means, simply put, is that government can strategically shape a capitalist system towards one set of parties over others. It is, in fact, through the articulation and implementation of strategies that the government fulfills its entrepreneurial role (especially in the production paradigm of capitalism), updating institutions to fit changing political, economic, and/or social circumstances. In an ideal world, government would update or re-shape the system to promote the general interests of society, which are often determined through political markets (e.g., elections and legislatures). More often, however, it falls at least somewhat short of this goal to favor certain private interests over others. At times, this failure may be the result of corruption, as private interests exercise influence over political actors such that the latter shape the system to favor the former.

It is at this point that the analogy between capitalism and organized sports falls short. The two are similar systems in that they operate on three levels, but there are some crucial differences, most of which stem from fundamental differences in the purpose of the respective systems and which become quite evident in consideration of the notion of strategy here.

The purpose of organized sports is to facilitate periodic competition among athletes, whether as individuals or as teams, both to encourage and recognize athletic excellence and to provide entertainment for the public. To this end, each sporting contest starts anew, teams are of equal size, and the advantages gained by a team during a game or a season are forfeited at the end of a game or season. In addition, and crucially, the entry of new teams is controlled by a system of franchises that may only be granted by a sporting authority; this authority in turn acts under an antitrust exemption and thus has sovereignty over its sporting league, like a state.

In contrast, capitalism, in its various forms, is intended to facilitate the productive use of societal resources in order to meet consumer needs in the short run and to raise the standard of living through time. As a result, its regulatory frameworks give priority to promoting productivity rather than the fine points of equalizing competitive resources on a given day or during a given season. At the same time, with rare exceptions, capitalism is regulated after the fact, and not in real time the way organized sports are. The regulators do not stop the play to assess a foul, nor do they halt the competition to examine a controversial event via "instant replay." The economy moves on, and disputes are settled after the fact, in court if need be.

The major contrast between organized sports and capitalism is that of a level, or not-so-level, playing field. While the institutions of organized sports are designed to ensure a level playing field, those of capitalism are not. To explain: Since economies of scale will enhance productivity, it follows that capitalism generally permits the accumulation of advantages, subject to certain exceptions and certain limits on acceptable behavior. It also follows that capitalism permits "teams"—i.e., firms—of radically different sizes to enter and exit industries without the approval of other participants, and it permits the entry of new competitors with new technologies that may give them an advantage over all other competitors. As a result, capitalism permits and encourages multifaceted competition among firms of different sizes using different resources on more than a single playing field (or industry) at a time. Capitalist competition, though regulated, is not designed to unfold between teams that are equal, nor circumstances that must be "level." Advantages, such as a playing field tilted in one's favor, become possible sources of additional—and potentially cumulative—advantages.

Since capitalism is designed to promote productivity, it can be expected to promote inequalities of income and wealth, and first movers in a technology may keep their advantages for decades. Capitalist competition is "for keeps", not for sport. And it is up to the political authority to strategically shape or tilt economic institutions such that the unequal outcomes of capitalist competition do not ultimately undermine greater political, societal, or cultural priorities, priorities generally set or expressed by the political markets. If the playing field slants too much in the wrong direction, those out of favor may react negatively through the political markets (i.e., elections, referendums, or even revolutions), replace the current political authority, and thereby attempt to tilt the market frameworks in a direction more favorable to their interests and, hopefully, those of general society.

The Political and Economic Systems Are Interdependent

As the foregoing section indicates and Fig. 2.4 illustrates, the political system and the economic system are inherently linked in a capitalist society; political markets influence the economic markets, and, in turn, the economic markets influence the political markets.

First, the outcomes of political markets directly determine the laws governing the economic markets and thereby indirectly affect their outcomes. Specifically, legislatures are responsible for the design of the market frameworks in law, while regulatory authorities specify and interpret the regulations to implement those laws, with these sets of political and administrative actors legitimated by government. The strategic governance of the market frameworks can also then be modified through the executive and judicial branches. While legislative, executive, and judicial forms of coordination are in this way all part of the governance structure of capitalism, it is the former that takes priority.

Legislatures are vital coordinating devices in a capitalist society; they bring different political actors or even political parties together to create compromises that, in theory, reflect conflicting interests and power relationships in order to achieve the public good. These compromises, again in theory, have taken into account all appropriate societal costs and benefits and thereby promote the interests of the middle class, in lieu of those of a wealthy elite or an aroused mob of the poor. In reality, this end is not always achieved, in that the political process does not always correctly

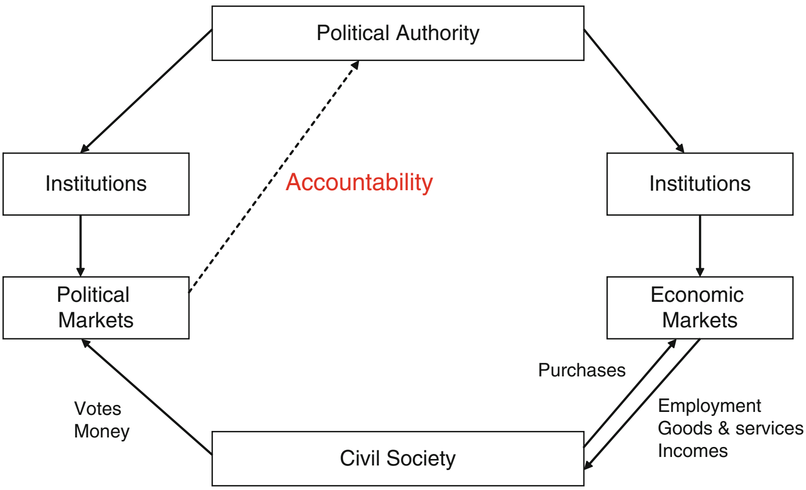

Fig. 2.4 Capitalism and democracy are interdependent systems of governance. Source: Bruce R. Scott

reflect true societal costs and benefits. Some costs are difficult to include, such as the costs of pollution, but typically because powerful interests resist their inclusion, through lobbying or other means; this is therefore not a market failure but instead a political failure. Other societal costs may be overlooked because politicians see them (or are encouraged to see them) as natural outcomes, such as the wages of low-skilled labor in a period of high employment and continuing immigration; this is, in fact, a political failure, given that the wage level is depressed not by the value of the labor performed but by weak bargaining power, a situation political actors could clearly mitigate. Supply and demand almost always reflect power relationships and thereby previous and current political considerations. Thus, in the reality of a capitalist system, the economic markets will not reflect society's true interests unless its political markets do.

But the political markets, as we have seen, can fail in this responsibility of identifying and balancing societal costs and benefits. The political markets follow no physical laws, like gravity or thermodynamics, but rather the actors' understanding of political as well as economic dynamics, an understanding that may be flawed (e.g., by poor research) or corrupted (e.g., by the financial influence of private interests). Could economic actors do a better job than political actors, evaluating the dynamics of the market and determining its frameworks? Perhaps so, but likely not in favor of the public good, and never with sustained legitimacy. Given their interested position within the market, any set of private actors would be biased in evaluating and then balancing societal costs and benefits. Moreover, these economic actors may well have the greatest knowledge of economic conditions and the most economic power, but they do not have the legitimacy to legislate or regulate beyond very narrow, mutually agreed-upon limits. Only political actors do, though they may of course misuse their legitimate power, both intentionally and not.

Economic markets are thus shaped by the (often imperfect) political markets of their respective legislatures. That shape is not set in stone; it can be changed by effective political pressures and intentional and unintentional asymmetries of information. Laws do not enforce themselves, and, in fact, they cannot even protect themselves from political pressures. Laws need continuous political support to survive. Thus, the system of economic governance is constantly and inseparably linked to the system of political governance, and it is the political system that has the legitimacy to shape the economic. However, the economic system is likely to have more information and a more targeted set of interests than the political system, so the agents of latter, i.e., politicians, are always likely to be in a position of trying to catch up to those of the former who have more knowledge and more money, i.e., businessmen. The political system will almost certainly make imperfect and sometimes even unwise choices, but it will in almost all cases determine the ultimate shape of markets, both economic and political.[36]

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[36]The United States is an important exception in that its Supreme Court can and has overturned legislative decisions that were explicitly designed to reshape market frameworks (e.g., those of the New Deal in the mid-1930s, elaborated on in Chap. 13).

Ideally, the political markets are themselves shaped to minimize such imperfect and unwise decisions and thereby maintain legitimacy. Successful capitalism needs a government that is based upon the rule of law, but not necessarily a democracy. A government of laws depends upon the creation of checks and balances established through the structuring of the political authority of the state, e.g., its constituent branches (executive, legislative, and judicial) and levels of government (federal, state, and local), to ensure that the state does not encroach on the private spaces reserved for civil society. Early examples of effective governments based upon the rule of law included limited monarchy, as in Britain or the Netherlands circa 1600, or even much earlier in the case of Venice, pre-dating the year 1000. Ultimately, the alertness and civic consciousness of society are essential if its elected representatives are to limit the state's interventions in the marketplace and the temptations of state officials to claim an excessive share of privately earned gains.

Any political system can expect competition between those who derive their power from the political markets and those who do so in the economic markets. Relative power of the actors will influence the tilt to market frameworks, directly by powerful political actors and indirectly by powerful economic actors influencing the former. Karl Marx supposed that liberal markets would be dominated by capitalists (i.e., powerful economic actors), which would lead to their domination of the political system as well. There was some truth to this at the time that he wrote, and it can certainly still happen today, but it is not a necessary outcome as he supposed. The tendency of capitalism to produce increasing inequality and eventually oligarchy over time is ever present, but it is a tendency that can be held in check, even if those checks are continually subject to challenge by would-be oligarchs, as we have see in subsequent chapters.

When it comes to holding this tendency toward economic inequality in check and thereby maintaining a legitimate political system, democracy has its advantages, given it is based on government of the people by the people. However, even democratically elected legislatures are imperfect; for instance, a 51% majority may be enough to impose its will on the minority without much compromise. Moreover, legislatures, however democratic in nature, can still be vulnerable to the influence of moneyed private interests (as in the case of the US, discussed later in Chaps. 13 and Chap. 14); a legislature that is dominated by concerns for the financial interests of the legislators can be expected to legislate for special interests and not for the people. As Abraham Lincoln implied at Gettysburg, government *by* the people is no assurance that it is *for* the people. But for the market frameworks of a capitalist society to best balance societal costs and benefits, the legislative markets must achieve outcomes that are both *by* the people and *for* the people. Thus we come to the crucial connection between the economic and political systems, or capitalism and democracy. Political leaders working through the political institutions of legislatures are responsible for shaping the institutions of capitalism such that the markets function *for* the people.

Note on the Appendix

Before proceeding to the conclusions, I would like to note that there is an appendix related to this chapter, which focuses on the role of firms in the capitalist system. I include this appendix because this chapter, and most of this book, focuses on capitalism as a three-level system from a broad viewpoint, as though we were on the outside looking in. However, there is a different angle from which to view this very same system, i.e., the viewpoint of the firm as a key actor. How does the firm—oft considered the essential requisite of capitalism—interface with these same three levels? I address this consideration in the appendix, further developing my theory of capitalism to include the role of firms within the economic system, with a particular focus on how these economic actors can influence the political system.

Conclusions

Capitalism is three-level system of indirect governance for economic relationships; it is a system that is political and administrative as well as economic. Organized markets cannot exist without a set of institutional foundations that establish various rights and responsibilities that are attributed to notions of property, and these foundations are created, legitimated, regulated, and periodically modernized under the auspices of a political authority such as a state. It is government and its agents, and not the private economic actors, who create and ultimately enforce the laws and regulations that guide production and trade. Since property rights are societal constructs and not gifts of nature, these rights will only take proper account of societal costs and benefits if they are established through a political process that is broadly representative of society itself, e.g., a democracy with a strong middle class. These issues of representation are the focus of the next chapter.

Capitalism has three major coordinating mechanisms, and not just one. Two of the three depend upon human agency, while the invisible hand of the pricing mechanism works automatically. One of the visible hands belongs to government, and it guides the system, whether explicitly or not. The other visible hand belongs to the management of firms, and particularly large firms. Unlike government, the visible hand of management can coordinate product flows and financial transactions on a multinational basis.

The visible hand of government has two modes of intervention in an economy, direct and indirect. The indirect mode of intervention covers the maintenance and operation of the institutional frameworks that underpin all markets. It is essential to the operation of a capitalist system, not optional. The direct role is much more optional, for example in the ownership and control of public enterprises or the taking of land by the powers of eminent domain.

Government also has two quite different roles to play in any capitalist economy: as an administrator and as an innovator. The state bureaucracy has most of the responsibility for the administrative role, but political leaders have the prime responsibility for choosing the key administrative personnel as well as for recognizing the need for entrepreneurial innovation in institutions, and for achieving them in a timely fashion.

If individual action is to add up to what it is best for society, then the regulatory and other institutional functions of government must get the market frameworks right as well as securing the property rights of the economic actors. Aside from the fact that there are no scientifically right answers, the extent to which economic markets take appropriate countenance of societal costs and benefits depends in large measure on how well the political markets of its system of governance reflect societal interests, a question we will consider in the next chapter. But the central point is that for economic markets to perform the coordinating function in the public interest, the political markets of that society must see to it that legislature represents those interests, and that its institutions work so that the outcomes are *for* the people and not just *by* the people or even by their representatives.

One of the geniuses of capitalism is that markets tend to be self-correcting when it comes to supply and demand; excess supply leads to a decline in price and a reduction in supply. However, market frameworks are *not* self-correcting. Market frameworks have no way to correct their own imperfections, such as the underpricing of pollution or the creation of excessive red tape. Only the intervention of the state can provide the necessary corrective measures to prevent capitalists or other organized groups from abusing the commons for their own advantage.

Capitalism depends upon government to do its job in managing and periodically modernizing market frameworks as circumstances change, including the modification of societal priorities as incomes rise. The appropriate modernization of market frameworks, including the tax and other policies necessary to avoid undue inequalities of wealth and power, requires the visible hand of government to make appropriate choices of policies and the mobilization of power for their enactment and administration. As a result a society without effective government has little if any chance of progressing from barbarism to opulence; instead it requires the visible hand of the state to intervene to modernize market frameworks in a timely way, while simultaneously administering and enforcing existing rights and responsibilities as a complement to the invisible hand of the pricing mechanism in its coordination of the production, distribution, and trade of goods and services within its economy. In the long term there cannot be effective capitalist development without effective governmental intervention to modernize its market frameworks in a timely and appropriate fashion.

Effective capitalism has a third coordinating mechanism as well; it is the visible hand of management as it mobilizes and allocates resources within the firms themselves. Firms control and coordinate product flows from one organizational unit to the next in a factory, and from one point in the supply chain to another on the outside. In addition, firms as well as capital markets coordinate the flows of capital into research and product development activities. Firms as well as markets have the capacity to be self-insuring so as to spread risks across a portfolio of development projects. Firms organized by function permit very specialized activities on a large scale and at high speeds. Firms organized by product divisions are able to bring some of the advantages of decentralized, market-based decision making within the firm while still retaining the advantages of scale and scope of a large firm. This latter type of firm also has something like an internal capital market within itself, and one where the top tier of management can intimately know the people and processes that are being managed in a context where they have more access to information than outside investors.

The trading view of capitalism is very well established, and indeed it seems to dominate Anglo-American economics. Unfortunately it has neglected some of the quite different characteristics that are involved in the factor markets, i.e., the markets for land, labor, finance capital, and most recently for knowledge. The factor markets are best understood in terms of the production paradigm rather than that of traders. It is the neglect of the factor markets, as though the factors were given and not subject to greater levels of mobilization or more effective allocation, that goes with the simplified neoclassical definitions of capitalism. A broader definition of capitalism makes room for a much broader understanding of the processes of economic development. The great strength of capitalism lies in its capacity to facilitate the development and adaptation of new technologies, including the possibility of higher levels of resource mobilization to achieve more rapid acquisition and adaptation of new technologies in developing countries.

This three-level concept of capitalism implies a continuing role for human agency in economic development. It also implies that there will be a continuing evolution of institutions and market frameworks as well the evolution of supply and demand within the markets. The focus on product markets, and how trade takes place within them, thanks to the invisible hand of the pricing mechanism, has narrowed the focus of contemporary economics toward a science of how markets operate to the relative neglect of the fact that none of those markets exist absent the institutional foundations created, monitored, and periodically modernized by governments. A broader, better definition of capitalism recognizes that without the essential and ongoing work of the visible hand of government to revise as well as enforce market frameworks, we would have much less developed capitalist systems. We might still have markets, like that of a roadside farm-stand, but we would also have unregulated mortgages turned into unregulated financial instruments and sold to unsuspecting investors with the help of meaningless rating systems supplied by unmonitored rating agencies in a process where the buyer must beware at least as much as in the pre-capitalist era. Capitalism requires more than markets and traders and commission agents; it requires the kinds of security of product specification and compliance that ultimately only government can ensure. And it implies an entrepreneurial role for government in regulating new markets as much as it implies opportunities for mortgage brokers and bond underwriters in exploiting them. Until we accept government's framework-defining role as an essential feature, we will not have a satisfactory understanding of capitalism as a system of governance.

Chapter 3
Capitalism and Democracy

Co-authored by Sarah Potvin

In the course of the 20th century, capitalism and democracy became the prevailing models for problem solving in their respective spheres of activity, the economy and the polity.[1] Obvious as this statement might seem today as a description of a changed reality, it calls attention to a remarkable transformation in the world and the perceptions of academics and policymakers. Capitalism became established in parts of Europe and North America well before 1800 and indeed well before it came to be known as "capitalism." It successfully faced challenges from socialism starting in the 1840s and from Soviet-style central planning in the early 1920s. Then, in 1990, state socialism, based on economic coordination through central planning, was spontaneously abandoned in all but a handful of countries, such as Cuba and North Korea. This left capitalism alone as a model for economic problem solving, both in fact and in theory.

The position of democracy has not been nearly so clear. Definitions of democracy—and, in turn, the tallying of democracies—vary a good deal, but the trend toward democracy as the dominant political system is unmistakable. Robert Dahl, a leading authority on the history and practice of democracy, has identified only six democracies out of the world's prevailing 43 countries as of 1900, only 25 out of 75 in 1950, and approximately 65 out of the 192 in 1990.[2] Thus, per his account, although democracy appears to have become the prevailing political model in a normative sense, it remains far from dominant in practice.

Though the majority of countries today have not adopted both capitalism and democracy, the two are arguably on their way toward becoming the prevailing societal models for problem solving, if the trend Dahl has noted continues. Thus, it seems worthwhile to investigate how well they really fit together.

[1] Almond, "Capitalism and Democracy."

[2] Dahl, *On Democracy*, 9. Freedom House's 2007 survey classifies countries as Free, Partly Free, and Not Free, based on scores along two scales, measuring political rights and civil liberties. The 2007 edition of this survey, which draws largely on data collected in 2006 in 193 countries and 15 territories, found 123 electoral democracies but rated only 90 independent countries, which hold 47% of the world's population, as "Free." See *Freedom in the World 2007* (Washington, DC: Freedom House, 2007).

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_3,

The relationship between these two systems of governance is neither easy to describe nor necessarily stable or entirely constructive. Political scientist Gabriel Almond writes that capitalism and democracy "necessarily interact with each other, and transform each other in the process."[3] Almond has not been alone in his study of the combination of these two pervasive and complex systems of governance; as he himself remarks, their dynamic relationship "dominates the political theory of the last two centuries."[4] There is a considerable literature in political science that examines when and how democracy has emerged within capitalist economies, and why capitalism seems to be a precondition for democracy. However, one can hardly say the same for economic theory or, even more broadly, for the literature in economics. Indeed, economics as a field turned away from the study of political economy about a century ago, as we saw in the previous chapter. While there is an extensive literature on how business interests can capture their presumed regulators and another on how public officials act in their own self-interest to the neglect of their public responsibilities, there is little on how private interests use their power to shape political outcomes and thereby shape the institutions of democracy, and to what effect. This gap should be of concern; if we accept Almond's view that capitalism and democracy interact with each other and transform each other, then we should be open to the idea that economic power can be converted to political power in ways that subvert political processes to favor the interests of a few at the expense of society.

The interactions between these two systems, while potentially pernicious, may be necessary to correct for failures in capitalist governance. I want to introduce the idea that the relationship between capitalism and democracy is asymmetrical so far as developmental issues are concerned. While democracy has accountability, in the form of a built-in feedback loop for correcting its "market failures" through subsequent votes or elections, capitalism has no such internal feedback loop that allows corrections of its market failures. The most obvious class of market failures in democracy are those wherein democratic government does not act in the public interest—i.e., when government *by* the people fails to equate to government *for* the people.[5] Corrections of failures in capitalist governance may and typically do require legislative or regulatory actions that are beyond the responsibility and/or control of the economic actors.

A number of the political science studies with which I am familiar have chosen to focus on the timing, form, and/or stability of emergent democracies within capitalist systems, while treating capitalism itself as a black box. In this chapter and this book, I plan to take a different perspective and focus instead on how capitalist systems have evolved and how this evolution is necessarily a matter of political

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[3] Almond, "Capitalism and Democracy," 468.

[4] Ibid.

[5] California provides innumerable examples of such failures of political markets, and their unfortunate consequences. Arguably, there have also been numerous market failures of US democracy that have arisen from the use of open primaries for the nomination of candidates. Both scenarios are discussed in Chap. 14.

economy, whether or not the political system is democratic. Given the overwhelming importance of democracy, especially in a normative sense, I find it important to broadly outline the institutions of democracy to understand how these two systems relate to one another. As I explore this relationship I will admittedly devote significantly less attention to democracy than to capitalism, but do more than treat it as a black box.

In the previous chapter, I defined capitalism as an indirect system of governance for economic relationships and noted that capitalist institutions can distort and/or obstruct economic development as well as promote it. In this chapter I want to deepen that analysis with further exploration of how the institutional foundations of a capitalist system can be created or reformed through the political process. In particular, I will explore how democracy can influence the process and outcomes of economic development. I faced some obstacles when putting together this analysis, both because my own background has focused on capitalism and because I was not able to find a comprehensive and operational definition of democracy that remained faithful to the nature of the system that it was to define. My approach in the body of this chapter is to ultimately suggest answers to five questions.

First, what does it mean to be a capitalist democracy? How do these two governance systems connect and influence each other? In answering this question I will expand upon the three-level framework developed in the previous chapter, identifying and examining how power and influence can be transferred from one subsystem to the other, and to what effect. Why are capitalism and democracy mutually supportive or symbiotic at times while apparently incongruous, antagonistic, or even inconsistent at other times?

Second, why has capitalism been found to precede democracy in all but a few circumstances, when it has accompanied rather than preceded it, and does this pattern indicate that capitalism is a precondition for democracy?

Third, if democracy works through competitive markets, what coordinating mechanisms cause behavior to adjust so that the interests of the individual align more or less with those of society?

Fourth, since there are still more than 100 non-democratic countries by some counts, can we identify the circumstances in which capitalist societies seem unable to achieve or sustain democracy? Or, more simply, what are some preconditions—beyond capitalism—for establishing and maintaining a stable democracy? While initial analysis may focus on developing countries, these circumstances and conditions may be useful indicators for the potential stability of developed countries as well.

Fifth and finally, if democracy is premised upon relative equality among voters and capitalism can be expected to produce inequality as a by-product of rewarding human initiative and risk taking, can we sort out the inevitable or even beneficial forms of inequality from those that may be traced to abuses of power, whether economic or political?

This chapter begins with a discussion of democracy as an emergent system of governance that comes in two distinctive forms, small scale and large. It is the latter form, or large-scale variant, that is of primary interest here. Unfortunately, the large-scale variant is exceedingly difficult to define in a way that is both comprehensive and operational. With the distinction between small scale and large in mind, this chapter will turn to the ideas of Robert Dahl, who provides a useful framework for considering large-scale democracy by employing the concept of polyarchy, or representation based upon competition among groups as well as individuals. This distinction, and the contrast between large-scale democracy and small, has some parallels with competition in a modern industrial economy, which is largely among firms rather than the individuals of the atomistic society envisaged in classical economics. This definition, and comparative analysis of large- versus small-scale democracy, works toward addressing the first and third questions.

With the benefit of a working definition and a brief history of democracy, the chapter moves to illustrate how democracy works as a system of governance by identifying the same three horizontal levels developed in the previous chapter to illustrate capitalism. These parallel structures, however, belie some important differences between the systems. For instance, unlike economic markets, political markets often produce winners and losers rather than just winners.[6] In this way, this section addresses question three by considering how political markets work to coordinate behavior.

The chapter then turns to the preconditions that are either essential or very desirable for the establishment of democracy; for example, one cannot expect to launch a democracy by drafting a constitution and holding elections in a situation where near-chaos prevails. Additionally, it will address the second and fourth questions by turning to the preconditions for establishing democracy and listing the conditions for the maintenance of a stable democracy through time.

Next, the chapter considers the uneasy tandem of capitalism and democracy as a single social system that is comprised of two vertical subsystems—one primarily economic, i.e., capitalism, and the other primarily political, i.e., democracy. These two vertical subsystems share a common political authority and a common set of citizen-consumers. With the help of a simplified drawing (Fig. 2.4). I suggest how they fit together, and indeed how power can flow from one subsystem to the other. These flows of power have the potential for symbiosis, as when rising incomes and wealth build support for democracy. But they also have the potential for antagonism, as when rising economic inequalities threaten the political legitimacy of democracy. Thus, question one is addressed.

The final section of the chapter explores theories of development and, in so doing, addresses all five questions raised for examination. I explore the issue of inequality—question five—through the idea that some forms of inequality are *passive or unintentional* by-products of the normal functioning of democracy while other forms of inequality result from the *deliberate* mobilization of economic and/or political power to influence outcomes for the benefit of a few at the expense of the many. While such self-centered use of power may, at the extreme, be illegal, e.g., bribery or extortion, my emphasis is on how power can be employed in ways that

[6]This assumes that market frameworks have taken appropriate account of the costs.

are antithetical to the common good but legal nonetheless. Large-scale democracy induces the use of mediating organizations, such as political parties, as essential elements of an effective system, and since these mediating organizations are designed to mobilize power, they can become important facilitators of, if not participants in, legal forms of corruption. It is important to explore how these active, purposeful, and potentially corrupt forms of behavior can create a pernicious form of inequality in capitalist democracies. Having sketched the two extremes in terms of the causes of inequality, I conclude that the gray areas may be more important than either extreme.

What Is Democracy?

Democracy, like capitalism, is an emergent, socially constructed system of governance that draws its legitimacy from the participation and thus the consent of the governed. It is, as Almond has stated, a problem-solving system that provides a framework in which human reason can be applied to the articulation and modification of institutions and policies for societal governance as circumstances change.[7]

I find it helpful to think of democracy as a system of societal governance that, like capitalism, is structured by three levels, as shown in Fig. 3.1. At the ground level are markets for political competition. Like capitalism, democracy has two quite different sets of markets, one for nominating and selecting leaders for office, i.e., elections, and another for selecting among alternative proposals to serve the people, i.e., a legislature.

This dual model, splitting democracy into two types of markets with two respective sets of institutions, reflects a remarkable structural change from the original democratic model. Democracy seems to have originated within and been limited to functioning in small communities where people were able to serve as their own legislators by participating directly in proposing and choosing among legislative proposals, a point I will return to shortly. Democracy for any good-sized city or

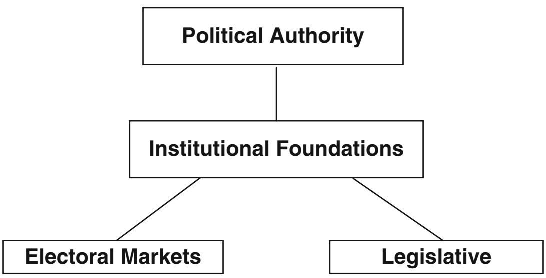

Fig. 3.1 Democracy as a three-level system. Source: Bruce R. Scott

[7] Almond, "Capitalism and Democracy."

province, let alone country, involves too many people for such direct involvement in the legislative process.[8]

Just as capitalism depends upon institutional foundations to provide a structure for its markets, large-scale democracy must also have institutional foundations. In the case of democracy, one set of institutions is necessary for the nomination and competition of candidates for office while the other set is necessary for governing the procedures that guide and regulate one or more legislative bodies. The institutional foundations of these two types of markets are quite different, as are their processes and indeed their purposes.

Electoral markets provide a structure for competition among candidates for office, whether in primary elections or a final round of competition. There must be rules of who may be a candidate, who may vote, and when the campaigning and voting may respectively take place. In addition rules define how the geographic districts in which the competition takes place are to be established. Should these districts be defined by politicians who might pursue partisan purposes, or by non-partisan groups whose mission is to reflect the broad demographics of the region? Which behaviors are allowed and proscribed in these particular markets? Are candidates allowed to spend as much money as they can mobilize for their respective campaigns, or are there limits on such spending? If the latter, who sets the limits, and who enforces them? The role that these institutional issues play in a democracy is comparable to that of property rights in capitalism.

Legislative markets dictate the distribution of power within the legislative branch of government and, in so doing, determine how democratic power is mobilized, channeled, and tallied. Legislative institutions may constrain or encourage majority rule, proportional representation, or other possibilities. The implications of the seemingly minor details and rules prescribed by legislative markets are far-reaching. For example, in a one-house legislature it is easier to have majoritarian dominance than in a two-house legislature where the two houses are chosen on different bases. Similarly, proportional representation makes it much more difficult to achieve a majority, usually necessitating compromises. Proportional representation is known for a tendency to produce unstable governments and a cumbersome process of legislating, but it allows the legislature to act as a coordinating mechanism across differing views rather than as a forum for majoritarian dominance. As another example, institutional structure also dictates the amount of staff support provided to help in drafting and reviewing legislation. Restricting staff support in the legislative branch serves to tilt power toward the executive branch, which can muster greater staff support; staff control by the majority party tilts the power of knowledge in favor of one party compared to another. As detailed in Chap. 14, US democracy has been profoundly altered by institutional changes aimed at deregulation. The addition of roll call votes, with the publication of individual member votes, has politicized each and every procedural vote in the United States; open subcommittee meetings let the "sunshine" in—along with the press and the lobbyists. Implications

[8]Dahl, *On Democracy*, 93.

of all these examples are compounded by the binding influence that a collective choice, as determined through legislative democracy, can exert on all members of a society.

In my view, Abraham Lincoln captured the basic rationale of democracy in his Gettysburg Address, delivered during the American Civil War, when he identified it as "government of the people, by the people, for the people."[9] While government *by* the people describes form and process, government *for* the people describes purpose and is thus inevitably about content and expected results. Lincoln's definition abstracts from many details to capture the essence of democracy—a problem-solving system that is supposed to deliver results in the public good. It reveals a more demanding standard than mere procedural democracy.

Lincoln's definition, for all its scope and acuity, is hardly operational. Most of the definitions that I have encountered are much more operational, but ultimately focus only on government *by* the people as though it assured government *for* the people. Unfortunately, it is difficult to say precisely what government for the people entails. Is it for people as individuals, as interest groups, or collectively, e.g., for the median voter? Whichever it is, how can it reach this objective? And what is it that makes the process legitimate? We can take the last question first, as it is the simplest to answer.

Government by the people implies that the basic source of authority for democratic government lies with the people themselves, as distinct from divine right, family inheritance, or control of military force. However, government for the people is fundamentally ambiguous, and leaves unanswered the conflict between collective and individual interests. Is the purpose of government to promote individual freedom, or should government try to assure all individuals in a society some measure of equivalent opportunity? How does one arrive at either result?

Government for the people is more easily defined and, as it were, achievable in the context of a small-scale democracy. Whereas large-scale democracy depends on indirect representation through elected legislators, small-scale democracy allows for direct participation by citizens who are more invested in understanding the implications of the choices they make. When democracy operates on a small scale, individual self-interest could result in democratic markets that operate in the public interest in much the same way that Smith identified for trading relationships in capitalism. If each individual were present at the various meetings where decisions were made, each could make his or her preferences known on each issue and attempt to persuade others. In any event, the tallies of these separate votes would at least lead to decisions favored by a majority.

However, majoritarianism does not necessarily provide optimal decisions for society. As the economist Kenneth Arrows writes, "voting, typically used to make 'political decisions, and the market mechanism, typically used to make 'economic' decisions," stand as "methods of amalgamating the tastes of many individuals into

[9] Abraham Lincoln, "The Gettysburg Address," November 19, 1863.

the making of social choices."[10] Voting, as "a method of arriving at social choices derived from the preference of individuals," offers only a collective preference, with no assurance of achieving a social maximum.[11] As Arrow concluded in his Possibility Theorem: "If we exclude the possibility of interpersonal comparisons of utility, then the only methods of passing from individual tastes to social preferences which will be satisfactory and which will be defined for a wide range of sets of individual offerings are either imposed or dictatorial."[12] Under a majoritarian scheme, the minority would lose on an issue, thus forfeiting their individual preferences without an opportunity to choose another way. However, Arrow's scheme bypasses the issue of representative government by identifying the act of voting as determining collective outcomes, rather than as selecting individual candidates, who themselves have no binding mandate to adhere to the preferences or tastes they advertised in their campaigns. Arrow poses the decisions made by the electorate as discrete preferences (i.e., person one prefers A to B to C), and he frames voters themselves as intractable, with clear preferences, clear expectations of the trajectory of their preferences, and aversion to compromise.

Arrow's model yields important insights for small-scale democracy but much less for the large-scale version. As Fig. 3.1 suggests, large-scale democracy has two sets of markets, and a bicameral legislature may, in some circumstances, be able to bypass the problem of aggregating individual preferences to arrive at decisions that approximate government for the people. For example, if the two houses of the legislature are controlled by different parties, a negotiation between the two houses may represent a very genuine compromise among two contrasting majorities. The two-house solution does not solve the puzzle that Arrow posed, but it could, nevertheless, serve as a method of approaching societal preferences. An electoral system based on proportional representation rather than the two-party, winner-take-all system prevalent in the United States would also be likely to arrive at decisions through negotiations among small parties in order to achieve a majority.

Political scientists have noted that democracy can neither claim nor deliver a process as optimal as the one that Smith identified for the (small-scale) economic markets of classical economics. The transformation of individual self-interest into optimal collective interest—in capitalism and still more in democracy—remains an ideal rather than an achievable standard. In their introduction to a recent work assessing "Democracy's Value," Ian Shapiro and Casiano Hacker-Cordón point out that government by the people is no guarantee of government for the people:

> In reality, democracy often disappoints. Both in its operation and in its consequences it fails to live up to the promise that people associate with it. . . . Far from reducing injustice and oppression, grinding poverty in the midst of opulent wealth persists in democracies across

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[10] Kenneth Arrow, "A Difficulty in the Concept of Social Welfare," *The Journal of Political Economy* 58, no. 4 (August 1950): 328.

[11] Ibid., 330.

[12] Ibid., 342.

> the world. Democracies manage to avoid war only with one another. Economic growth can occur as well without it as with it. . . . At best we can perhaps say that the democratic ideal lives in adaptive tension with the political realities in most so-called democracies. At worst it provides a misleading gloss for practices that scarcely deserve the name.[13]

Large-scale democracy must confront some very difficult practical problems. Small-scale societies, whether a local club or a small village or town, permit direct democracy wherein people can meet in a single location, interface directly, and act on their own behalf as though they were the legislature. Large-scale democracy requires either some form of representative government, i.e., a republic, or some form of communication and polling to allow people to participate without the face-to-face contact so emblematic of smaller-scale politics. As James S. Fishkin explains, legislators in large-scale democracies have a potentially contradictory mandate, beyond their party obligations, "to represent the wishes of the constituents, to do what one thinks is best, and to represent the hypothetical informed views of constituents."[14] In addition, large-scale democracy confronts voters with a very different set of choices than those available to consumers in the consumer markets of capitalism.

In this book my concern is essentially with large-scale democracy, or a republic, wherein representatives are elected. Large-scale democracy, however it is organized, is a radically different form of governance than capitalism in spite of the fact that both are built around decentralized decision-making through markets. I will return to this comparative analysis of capitalism and democracy later in this chapter, to help explain why the political markets of democracy can only approach but never expect to reach the notion of government for the people to the same degree that Smith could claim for the markets of capitalism. For simplicity, I will refer to large-scale democracy with the same term that applies to its smaller-scale cousin, i.e., democracy.

As we have by now seen, democracy is a matter of degree and dimension. Robert Dahl counts inclusiveness as an essential characteristic of democracy, while also noting that democracies can be more or less inclusive in who is allowed to participate, and more or less liberal in the political and civil rights guaranteed to their citizens.[15] In this process-oriented view, democracy is not a dichotomous proposition of yes or no; rather, it is a relative term that varies in several key dimensions, including inclusiveness and entrenched rights for the participants. Seymour Martin Lipset also takes a process-oriented approach in providing a much-used definition of democracy "as a political system which supplies regular constitutional opportunities for changing the governing officials, and a social mechanism which permits the largest part of the population to influence major decisions by choosing among

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[13] Ian Shapiro and Casiano Hacker-Cordón, "Promises and Disappointments: Reconsidering Democracy's Value," in *Democracy's Value*, ed. Ian Shapiro and Casiano Hacker-Cordón (Cambridge: Cambridge University Press, 1999), 1.

[14] James S. Fishkin, "The Nation in a Room: Turning Public Opinion into Policy," *Boston Review*, March/April 2006.

[15] See Dahl, *On Democracy*.

contenders for political office."[16] Both of these definitions focus on government by the people, and neither explicitly sets a threshold for the notion of liberal democracy based upon a rule of law that would presumably give equal protection to all citizens. However, more remains to be said about government by the people, and I will return to the subject after some further consideration of democratic purpose.

While no country can claim to have a perfect liberal democracy, wherein all are assumed to have certain basic political and civic rights or freedoms, including the expectation of equal protection of those rights under the law, I believe that it is important to explicitly set it as the democratic ideal of government for the people. This will immediately help us distinguish "democracy" from "people's democracies," such as the former East Germany or the People's Republic of China, where the candidates are chosen from above, and the citizenry cannot count on equal protections under a rule of law. Social scientist Kenneth Bollen identifies *liberal* democracy as

> [T]he extent to which a political system allows political liberties and democratic rule. Political liberties exist to the extent that the people of a country have the freedom to express a variety of political opinions in any media and the freedom to form or participate in any political group. Democratic rule (or political rights) exists to the extent that the national government is accountable to the population, and each individual is entitled to participate in the government directly or through representatives.[17]

Since there can be more and less democratic regimes, it follows that establishing metrics for measuring the extent to which a system allows participation in elections and competition to select candidates would be valuable when assessing democracies. It also implies the value of a set of metrics that measure the extent to which government is accountable to the population. When measuring democracies, social scientists define democracy, identify traits, and attempt to measure the presence or absence of these traits through objective indicators. Of course, as Bollen has pointed out, "The controversy in measuring liberal democracy parallels the debates about the meaning of the construct," and no real consensus exists on that central definition.[18] Rather than attempt quantification of performance as more or less for the people, I propose to ask what structures and operating principles are necessary to establish and maintain a system that accepts the goal of being for the people. This should be a less demanding question, yet it will allow us to gain insight into why the connection between actual, procedural democracy and government for the people is so tenuous, as Shapiro points out.

Before delving into measurement and assessment, however, it is important that we better understand the systems—capitalism and democracy—that we seek to

[16] Seymour M. Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53, no. 1 (March 1959): 71. Quoted in Tatu Vanhanen, "A New Dataset for Measuring Democracy, 1810–1998," *Journal of Peace Research* 37, no. 2 (March 2000): 251–252.

[17] Kenneth Bollen, "Liberal Democracy: Validity and Method Factors in Cross National Measures," *American Journal of Political Science* 37, no. 4 (November 1993): 1208–1209.

[18] Ibid., 1210.

gauge. In theory, capitalism is a system of governance for economic relationships, while democracy is one for political relationships; but, in reality, the two systems are intertwined, starting from the fact that they share a common political authority, i.e., government, and serve a common constituency, i.e., civil society, that includes producers as well as consumers. Government plays a vital facilitating role in capitalism, as we saw in the preceding chapter. It must establish, legitimate, modernize, and administer the institutions of the capitalist system, while standing aside to allow the competitors to compete within the various market frameworks. It follows that government plays an essential—if largely indirect—facilitating and regulatory role in the creation of new wealth. However, just as government must have certain powers and capabilities to facilitate an effective capitalist system, it must have adequate powers—and certain restraints—for its political role.

Democracy, like other forms of governance, implies the capacity to mobilize and exercise power. A democracy can fail if a government and the state bureaucracy that it directs have too little power or administrative capability to meet their responsibilities. On the other hand, a democratic government can regress into an authoritarian regime if it is not effectively constrained. A democracy can continue to be successful if its firms perform poorly, but it will fail if its political leaders usurp unauthorized powers or do not meet their responsibilities to their constituents.

The Role of Markets in Democracies

It was Adam Smith's great insight that markets, where people are permitted to trade their money for goods and services, can maximize societal welfare as individuals pursued their self-interests. Put simply, his theory is that the crucial linkage between self-interest and public interest is to be found in the coordinating role of the price mechanism. Prices did not just reflect buyer preferences, like votes in a political system; they induced buyers and sellers to adjust their behavior in ways that promoted societal welfare without, as Smith stressed, necessarily being aware of it let alone intending to do so. However, Smith's model assumes atomistic competition among many buyers and sellers, with many closely similar offerings from a variety of suppliers, none of whom has significant market power. In addition, Smith's model assumes the existence of market frameworks that reflect appropriate societal costs and benefits.

The political analog to atomistic competition lies in small-scale democracy, like a town meeting or even the meetings of smaller-scale associations, such as those for a tennis club or a housing development. As in the atomistic competition of economics texts, individuals in a small-scale democracy are expected to appear at meetings to speak to make known their demands, and eventually to vote and therefore to legislate for themselves. In this "supply side" view, voters can make their own proposals, speak for them, amend them, and eventually vote for them—essentially, they can effectively practice deliberative democracy. While factions and/or parties are not unknown, they are unnecessary and often unwelcome in small-scale democracy.

The characteristics of a town meeting do not apply to large-scale democracy any more than atomistic competition adequately models a modern industrial economy. In the large-scale democratic context, the supply side of preferences is proposed and supported by factions and/or parties; although allegedly organized to serve the interests of their adherents, these parties are historically "more interested in competing for office than deliberating about policy."[19]

Political markets are also very different from capitalist markets on the demand side. A voter does not get to pick and choose individual political products or policies in political markets the way a consumer can exercise choices in a product market. In the political system, the voter has only a few "suppliers"—or party programs or platforms—to choose from, and each supplier offers a very complex bundle of choices, which may not be clearly defined but in any case are bundled on a take-it-or-leave-it basis. Whereas a capitalist consumer likely has the option to purchase a wide variety of consumer goods from a variety of outlets, a voter must choose a single supplier who promises to provide national defense, health care, environmental protection, and many other goods and services as a bundle. Moreover, the voter has no personal agency to alter the bundle offered by the party, beyond perhaps splitting votes for different parties at the local, regional, and national levels. Ultimately, decisions are made at the level of the legislature, not the individual voter, and political parties limit the deliberative role originally intended for unaffiliated elected legislators.

This aggregation of political preferences suggests that Dahl's polyarchy is much like the oligopoly of economic theory, insofar as both describe a concentration of power beyond atomistic competition or perfect democracy. Polyarchies host a variety of groups of unequal size, all of whom try to mobilize voters as a way to gain market power. Large-scale democracy is based upon voter aggregation through factions and political parties, each of which has its vision of how a country or state should be run, a brand image of what it stands for, a marketing program to try to win supporters, and a cadre of professionals who try to coordinate its various activities. Such groups provide a vehicle for the mobilization of funds as well as votes, and they can bid for the support of think tanks, public relations firms, fundraising organizations, and pollsters. Unsurprisingly, parties normally have control of who may run for office under their banner or brand. However, as Chap. 14 will explain, the major political parties in the United States gave up their ability to control which candidates would stand for election following a crisis of legitimacy in 1968. The consequences of this change, which opened primaries to competition based mostly upon private financing, have been far-reaching.

In reality, the organized groups within a polyarchy are nothing like the neutral "supply" forces of an atomistic economic market, because they are ultimately focused on articulating a party platform that will attract the number of votes necessary to win an election. Ironically it was Joseph Schumpeter, in his *Capitalism, Socialism and Democracy*, who de-linked "democracy's legitimacy

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[19] Fishkin, "The Nation in a Room: Turning Public Opinion into Policy."

from any pretense that politicians represent voters. Instead, Schumpeter modeled his democratic theory on the neo-classical theory of price competition: just as firms compete for business in market systems, would-be political leaders compete for votes."[20]

Political markets themselves are also very different from economic markets on the demand side, in the sense that they are not based upon the notion of voluntary exchange where both sides can be presumed to be making a transaction that will leave them better off. Electoral markets are characterized by winners and losers, and not the mutual winnings of participants in a product-market. Legislative markets have the potential to achieve remarkable feats of coordination through compromise but do not always do so: outcomes are not necessarily mutually beneficial, nor are the transactions necessarily voluntary for the parties. Furthermore, a voter's life is changed by a legislative decision whether or not he or she participates. Legislative markets are often contests between opposing parties for the control of the coercive powers of the state.

In large-scale societies, political markets lack a function analogous to the price mechanism in economic markets, which, under ideal circumstances, assures optimal outcomes by inducing adjustments of supply and demand. While economic markets can rely upon relative prices and quality levels as coordinating mechanisms to achieve socially optimum outcomes, political markets cannot count upon the existence of a similar mechanism to induce behavioral adaptation and thereby induce an approximately optimum outcome. The opportunity to buy apples instead of oranges, or "Brand Y" instead of "Brand X," underpins the coordination powers of the pricing mechanism in economic markets, aligning the preferences of many independent consumers with the offerings of many competing suppliers. Legislative markets devise social choices, perhaps with due consideration for appropriate societal costs and benefits, and negotiate decisions that may approach decision-making for the people, but the societal optimum remains an elusive goal, unattainable by simple centrist majoritarianism.

Political markets often finesse a very important ideological tension between society and the individual; are they to discover and decide what is best for the people collectively, as in the concept of the common defense or the common good, or to provide the maximum in free choices for the people as individuals? Can they be both at once? If the purpose is to promote individual freedom and opportunity, does this presume that all individuals start with somewhat equivalent resources? If not, and if all persons are considered to be of equal political value, is government obliged to assure that all individuals have some minimal—if not equivalent—level of opportunity? If government tries to provide at least certain basic opportunities for all, can this be achieved without detracting from the freedoms of some?

Competition in legislative markets is primarily about mobilizing resources (e. g., human, financial, etc.) to win power, in this case the power to control the coercive powers of the state. Winning a legislative vote is not like agreeing to a deal in an

[20] Shapiro and Hacker-Cordón, "Promises and Disappointments: Reconsidering Democracy's Value," 4.

economic market. In the latter there may be two or more winners, and perhaps no losers. However, in a legislature the differences of a few votes may spell the difference between winning and losing in a contest where the stakes are exceedingly high; a new law, once established, may set a new pattern of control that will last for years or even decades. Furthermore, the rules on when and how a piece of legislation may or may not be amended, or how the votes are to be counted, may spell the difference between winning and losing.

Parties can appeal to voters in different ways, based upon economic interests, social values, or even ethnic or sectarian loyalties. Competition based upon economic interests might be expected to pull competing parties toward the center, in order to appeal to a middle class constituency or even a hypothetical median voter. But competition based upon ethnic or religious affiliations can be divisive, and the more open the competition the more divisive it can become. If the ethnic or sectarian differences also happen to be regional, then open electoral competition can be still more divisive. Such possibilities can present very considerable risks for liberal democracy; unless certain kinds of speech are prohibited as sectarian, racist, and/or inflammatory, electoral competition can threaten the stability of the system. Electoral competition can polarize an electorate and destabilize a country, as happened in Malaysia in 1969 and more recently in post-conflict Bosnia and Lebanon.[21] Much the same is true if there are fundamental differences over social institutions, such as slavery in the United States up to and including the election of 1860. Open, competitive elections are much better suited to societies that are relatively homogenous and/or have established traditions for tolerance on basic social issues. Thus, free and fair elections are an optimal formula for democracy, but not for all situations. Democracy, like capitalism, requires the development of certain institutional foundations that should precede constitutions and elections, as we will see below.

In fact, democracy can legitimate a tyranny of the majority, as in "one man, one vote, one time." The framers of the US Constitution hoped to mitigate such risks through a series of checks and balances. They established a bicameral system, with terms staggered to avoid precipitous shifts in power. Certain powers were reserved to the states, and others to the people, with the executive and legislative branches set up to check one another. And certain actions, such as constitutional amendments, required a super majority. But no matter how well set up, the markets of democracy lack the coordination mechanism of the markets of capitalism; the markets of capitalism, when properly established and maintained, have the capacity to host an invisible hand that automatically coordinates individual behavior and collective interests. If legislatures achieve good compromises, they do so by visible hands

[21] For example, Malaysia has ethnic, racial, and religious divisions that are also geographic, and that invite violent competition among its constituent peoples. To deal with such possibilities Malaysia adopted a Constitution that entrenched certain rights and prohibited debate on certain of its principles, even by members of parliament when meeting officially as an organ of the government. An alternative approach, in the United States, protected free speech that led ultimately to secession of the South and to Civil War in 1861.

that, for example, represent centrist interests and a middle class; there is nothing automatic about such outcomes and such trade-offs.

What qualifies as democracy is in part in the eye of the beholder; indeed, what qualifies in one era might not in another. When Alexis de Tocqueville visited the United States in 1830 to conduct research for his classic volume, *Democracy in America*, the United States was closer to meeting democratic standards than any other nation at the time in terms of allowing broad male participation in free and fair elections that would determine the membership of the various legislatures and executive offices that governed the nation and its component states and communities. Nevertheless, at the time of de Tocqueville's visit, the United States had slavery and maintained an array of property-ownership requirements for suffrage in the only group allowed to vote: white males. By contemporaneous standards, the US system was a marvel, allowing for government of the people by a large fraction of the adults, while denying the vote to half of the population because of gender, excluding another large fraction on grounds of race, and disallowing still more because of failure to meet the property test. Despite the fact that it clearly was not government by the people in a modern sense, de Tocqueville's analysis implied that it was far closer to government for the people than any other at the time. By today's standards of universal participation and suffrage, however, the United States was not a democracy until the 1970s.

Democratic Capitalism

I have defined democracy as a three-level system that parallels the three levels of capitalism. Since they have their respective purposes and institutions, it becomes important to ask how they connect, and to what effect. Surely one of the crucial things to say about this relationship is that the connection between capitalism and democracy is asymmetrical, and this asymmetry has crucial implications for our whole story on the evolution of capitalism. Capitalism is naturally recognized as having feedback loops that run though its markets. For instance, changes in supply or demand can be expected to bring adjustments from suppliers and buyers and adjustments in price as well. However, all of these adjustments fall within the market frameworks. If capitalism has a flaw in its market frameworks, such as a negative externality that has been omitted or underemphasized, that market imperfection cannot normally be corrected through the institutions of capitalism. This is in stark contrast with the feedback processes in democracy. In a democracy, the political system has a feedback loop that permits and even calls for self-correction, as suggested in Fig. 2.4 (p. 60). As implied by the upward sloping arrow in the figure, the voters in a democracy have the possibility to react to an imperfect policy by demanding reform, or at the limit by voting against an incumbent politician or government. These votes against government are inherently part of the system; government should expect them, and at the limit, be prepared to accommodate them at the risk of being voted out of office. That is all part of the beauty of the process of building and maintaining consent.

However, the capitalist subsystem has no such feedback loop within the boundaries of capitalism because any such protests would have to pass through the political system if it were expected to force a change in the laws or regulations. Instead, the capitalist system can register a decline in demand; this may well force adjustment among other economic actors within the market frameworks, but it will not necessarily require any notice among the political actors. The market frameworks of capitalism are authorized and indeed created, legitimated, enforced, adjudicated, and modernized within the political process. Unless a legislature takes notice, and the requisite number of political actors mobilizes the votes to force a change, none should be expected. This is of crucial importance, as I will describe.

Capitalism, unlike competitive sports, requires continuous adjustment to changing conditions, including changing preferences among buyers and sellers. The purpose of the markets of capitalism is to force adjustments that will improve the allocation of resources to both satisfy demand and boost productivity. Effective capitalist systems must adjust, or suffer the consequences. Unless new technologies for manufacture are allowed, production and even distribution will move elsewhere. As Thomas Jefferson wrote, "I am not an advocate for frequent changes in laws and constitutions, but laws and institutions must go hand-in-hand with the progress of the human mind . . . We might as well require a man to wear still the coat which fitted him when a boy as civilized society to remain ever under the regimen of their barbarous ancestors."[22] Democracies must be able to adjust their institutions to reflect and encourage certain changes.

In reality the challenge is even more crucial than Jefferson suggested. A legislature could indeed require institutional changes that forced all adults to wear the clothes of children, so to speak. It could, for example, ban motorized transport and insist that transport use the traditional forms, where animals pulled wagons. However unlikely such an event might be in a secular society, a similar effect might be achieved by approving the usage of an unsafe technology or medicine, or by denying the right to use one that would save lives. While all of these examples may seem far-fetched, the European Community requires the testing of all new chemicals before they can be sold on the market, much as the United States does for pharmaceuticals for human usage. The United States considers such a rule to be unwarranted interference with private decision-making.[23] Permission for the right to distribute genetically modified seeds poses similar issues, where there may or may not be justifiable scientific differences owing to the modification.

Differences such these must be resolved as globalization progresses. Regulation of the financial services sector will be a particularly important example, as we will see in Chap. 14 and the Epilogue. A belief in self-regulating markets was used as justification by the US Federal Reserve system for ignoring existing regulations, for example, those requiring down payments on mortgages, and by the US Congress for

[22]Thomas Jefferson, "Letter to Samuel Kercheval," July 12, 1810, http://www.monticello.org/reports/quotes/memorial.html. As excerpted and inscribed on the Jefferson Memorial.

[23]See Arthur A. Daemmrich, *International Lobbying and the Dow Chemical Company* (A), unpublished Harvard Business School Case draft, November 2009.

prohibiting regulation of derivative securities. While we will return to such examples much later in the book, it is important, here, to assert that rules emanate from the political process and not from economic markets. Ultimately the competitiveness of a capitalist system depends on the effectiveness of its democracy to govern. Lobbyists may enhance or impede that effectiveness, but they cannot normally transfer the approval process for laws and regulations from the political process to the domain of the capitalist system. Democracy is not necessary for effective capitalism, but effective political governance is. As democracy is the norm for such governance of capitalist systems, the effective democracy is, it follows, integral to the effectiveness of a capitalist system. But how does a democracy govern effectively? A good—and, indeed, foundational—model comes from the simpler systems in place in ancient democracies.

A Very Brief History of Democracy

Democracy is an ancient idea that was little practiced prior to the 20th century.[24] The idea of democracy is traced to the Greeks in about 500 BC, when it was also adopted by the Romans. In both cases, democracy was practiced for several centuries before being overthrown, by external forces in the Greek case and by internal decay and the eventual creation of a dictatorship in the Roman. Despite their different names, the Roman republic and the Greek democracies were quite similar in many respects, yet no similar form of governance would appear again for almost a millennium, when new variants emerged in the Netherlands, Scandinavia, and Switzerland.[25]

Greek city-states had a small enough population of citizens, the *polis*, that they could meet face-to-face to make decisions. At the time, these city-states had largely agricultural economies characterized by relatively small farms and thus relative equality among their citizens. They were considered democracies in spite of the fact that women and slaves were excluded from participation in the political process. In this context of very small-scale political units and relatively equally distributed wealth and power, the Greeks practiced direct democracy in a process similar to that which prevails in small towns in New England in our own time. Both contexts grant the opportunities for all members of a community to be present at a town meeting, and for all present to speak and then vote on legislative proposals. Certain details differ: Whereas New Englanders typically elect town officials for terms of several years, the Greeks often chose their leaders by lot, even their generals, and limited their terms of office to 1 year.

Rome started as a city-state and grew through conquest to encompass an empire on three continents. While it granted citizenship to many people in conquered lands, it failed to create a multi-level structure of government that would accommodate the political participation of those at great distances from Rome. Thus, to be a citizen

[24] See Dahl, *On Democracy*.

[25] Ibid., 17–21.

of Rome who lived a hundred or a thousand miles distant from the capital city was effectively to be disenfranchised from participation in government. To govern an empire through a single set of legislative institutions in a single city meant that great and largely unchecked powers were given to provincial governors.

Interestingly, neither the Greek nor Roman experiences left a significant legacy in southern Europe, except through ideas preserved in the written records, according to Dahl. Then, after almost a 1000-year lapse, democracy reappeared in relatively small-scale settlements in the Netherlands, Switzerland, and Scandinavia. In some cases, such as Iceland, Vikings established an elected "national" assembly as well, while regional assemblies and then national assemblies sprang up in Norway, Denmark, and Sweden.[26] Similarly, popular rule materialized in northern Italian city states around the year 1100, but, with the exception of Venice, a limited monarchy which became a city empire, none would have the scale to defend themselves from their larger neighbors such as France, Spain, or the Papacy, a situation I review briefly in Chap. 5. A tension persisted in the early models of representative governance; "small was beautiful" in terms of the internal processes of governance, but it was not beautiful for self-defense nor, as later history would show, for mastering other issues of the economy or the environment. Representative government at the time was less democratic than is expected today, but limits on transport and communication thwarted the geographic expansion of city-states and therefore the need for a less direct government.

Dahl credits James Madison with introducing a distinction between the heretofore identical concepts of popular government implied in the terms "republic" and "democracy" in a 1787 paper supporting the new Constitution.[27] Republican, or representative, government was framed as an adaptation of "pure democracy." Republican government, while less democratic than direct democracy, permitted an indefinite extension of bottom-up government. The modern, large-scale state typically employs a representative form of government at several hierarchical levels, e.g., federal, state, and local, with the higher levels addressing broader questions and aggregating political support for decisions. Representative government in turn requires a way to select representatives and a way to mobilize voting power in a legislature. Both of these tasks are managed through the variety of more or less formal associations or factions of polyarchy, and frequently through formal political parties, i.e., through institutions that are neither necessary nor indeed welcome in small-scale democracies.

Polyarchy

Dahl identifies factions or parties as institutions that are emblematic of modern, large-scale representative government, or "polyarchy." Inclusive polyarchy,

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[26] Ibid., 20.
[27] Ibid., 16.

or government through many centers of power, invites liberalization and broad participation in the selection of representatives through the use of intermediate forms of association or organization.[28] It recognizes that the democratic ideal of direct popular participation in self-governance and total governmental responsiveness to citizens is unattainable.[29]

In answer to the question "What is democracy?" Dahl responds that it should provide opportunities for:

1. Effective participation
2. Equality in voting
3. Enlightened understanding
4. Exercising final control over the agenda
5. Inclusion of adults[30]

Exploring the definition of democracy, I begin from Dahl's criteria because they provide a useful framework for thinking about what it means to have government by the people. They imply that democracy, when understood in the above way, can be impaired through intimidation, corruption, or an unequal distribution of resources. But these characteristics present only part of the picture; they focus on markets for the nomination and election of candidates, rather than on legislative markets that will reach decisions on public policy. Thus, Dahl's descriptions do not address government for the people—specifically what institutions or processes might be beneficial or essential to substantive outcomes in the communal interest. While inclusive polyarchy, with its many centers of overlapping power, is as close as one is ever likely to get to political equality in a moderately large society, the potential to transfer power and money from the economic system to the political system persists. How can a society that is organized through political groups approach political equality among its members, when economic resources within the society are likely to be controlled by groups, from volunteer organizations to corporations, and thus very unequal? Dahl's concept of polyarchy allows us a starting point to assess how inequalities may be balanced within an imperfect democracy, and to identify the conditions necessary or favorable for democratization, but it is only a starting point.

Favorable and/or Essential Preconditions for Democracy

Since there are still some 100 societies that are organized as at least quasi-authoritarian regimes, it is useful to try to identify conditions that are either

[28]Robert Dahl, *Polyarchy: Participation and Opposition* (New Haven: Yale University Press, 1971).

[29]Robert Dahl, *Toward Democracy: A Journey, Reflections 1940–1997* (Berkeley: Institute of Governmental Studies Press, University of California Berkeley, 1997), 93–99.

[30]Dahl, *Toward Democracy: A Journey, Reflections 1940–1997*, 61–79, 98; Dahl, *On Democracy*, 38. In *On Democracy*, Dahl adds "Alternative sources of information" to this list.

necessary or favorable for the establishment of democracy. Dahl identifies five such conditions,[31] which I have compiled in a single list. I have added four more conditions that seem particularly important to the establishment of democracy in post-conflict conditions. Dahl also notes that, while his five conditions are "crucial," "other conditions would also be helpful."[32] The first three conditions I have added fall into the first category, while the last one falls in the latter. Fulfillment of each of these conditions could be estimated on a scale, though perhaps not with fully objective indicators, and the scores could be tallied and compared. A country need not have a perfect score to have the opportunity to succeed at democratic polyarchy, though, as Dahl notes of his own conditions, "a country that enjoys all five of these conditions is almost certain to develop and maintain democratic institutions," while a country "that lacks all five . . . is extremely unlikely" to do so.[33] All that I can suggest is the need for a high score, however specified, as a necessary condition for establishing a democracy; a wide variance is certainly possible among "qualifying" scores. Simple as it is, setting out a set of conditions for successful governance is a radically different and much more complex approach than establishing a constitution and holding elections as though such minimal measures constitute the essential preconditions of democracy.

Dahl's conditions[34]

Essential:

1. Control of military and police by elected officials
2. Democratic beliefs and political culture
3. No strong foreign control hostile to democracy

Favorable:

4. A modern market economy and society
5. Weak sub-cultural pluralism

My addendum

Additional essential conditions:

6. Monopoly of coercive power resides with the state (e.g., there are no armed militias under private control, no patron–client relationships that employ extrajudicial coercion, and no control of judicial proceedings by religious authorities)

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[31] Dahl, *On Democracy*, 147; Dahl, *Toward Democracy: A Journey, Reflections 1940–1997*, 99–105.

[32] Dahl, *On Democracy*, 159.

[33] Ibid.

[34] Ibid., 147.

7. Security for persons and property
8. Acceptance of the values of the Enlightenment

Additional favorable condition:

9. Elected officials enact the laws, state regulators interpret and monitor them, and state courts adjudicate them

Dahl's list of necessary and favorable conditions seems appropriate for developed countries with long-established traditions of order. However, since the establishment of internal order for some former colonies or failed states is often as fundamental as the establishment of independence from foreign control in these territories' transitions to democratic nation-states, I have added criteria 6, 7, and 8. Number 9 is implied in a monopoly of coercive power, but I have singled it out for emphasis.

Establishing order often means dealing with sub-cultural pluralism. Sub-cultural pluralism can easily become a source of dysfunction and, at the limit, a cause for violence. Catholic–Protestant differences in Ireland are an obvious example, and French–Flemish differences in Belgium a milder example. Wherever cultural, religious, or racial differences are concentrated in geographic regions, these problems tend to be more severe, as has been the case both in Ireland and Belgium. The United States has many such differences, but they are more diffuse, more like a tossed salad than the more famous melting pot analogy. My criteria are geared toward mitigating the problems oft induced by sub-cultural pluralism.

Criteria 6, 7, and 9 extend Dahl's first criterion, which calls for the "control of military and police by elected officials." In my view, any state that is to serve a democratic government must have a monopoly of coercive power if democracy is to be successfully established and sustained. This monopoly implies that the state has adequate power to protect its citizens and their property, typically through military and police force. Since regulators and courts also exercise coercive power, this power must also be under the control of the government. A democracy cannot really function alongside independent armed militias. If there are organized criminal gangs, as with the Mafiosi in the Mezzogiorno, or the so-called death squads in Colombia or Iraq, democracy is compromised. More subtle and far more common is the patron–client relationship, in which the patron exercises extrajudicial power to reward and intimidate his or her private clientele within a local area. Patron–client relationships are likely to constitute a serious problem in any post-conflict situation because they can spring up quite spontaneously as the traditional forces of law and order are overthrown. Patron–client relationships can also appear in any country characterized by very unequal power relationships, as in the US South in the era of segregation—where "a dual system that is competitive with respect to the dominant group and hegemonic with respect to a deprived minority" was installed[35]—and as in much of Latin America throughout its recorded history. Any such relationships

[35] Dahl, *Polyarchy: Participation and Opposition*, 94.

can obstruct the free and fair functioning of elections and the effectiveness of the state in protecting persons and property.

I have added the notion, in criterion 8, that a democratic society must accept the values of the Enlightenment, meaning a reliance on human reason as the ultimate source of authority for the settlement of disputes. In practice this criterion usually necessitates a separation of church and state. A democratic society, through its elected officials or through direct referenda, must have a monopoly on the right to enact, interpret, monitor, modify, and adjudicate the laws. This means that no religious organization can either enact such laws or claim to be the interpreter of ancient texts that define such laws. For example, while the Catholic Church had such rights in the 16th and early 17th centuries, including the right to try religious heretics in church courts and to execute those found guilty, the state was not fully in control of the legal system. Europe escaped from this situation in the 17th century, but not without bloodshed. An analogous problem exists today for countries where an important and highly mobilized fraction of the population may insist that religious law must be observed as the ultimate guide to the laws of the land. Where this condition exists, scholars research the ancient laws and traditions as guides to legal behavior today, and fundamentalists seek to override the separation of church and state as a basic characteristic of democracy. It may well be that the critical difference among countries with fundamentalist segments in their populations lies in the relative power of such groups to retake this legal function through the political process.

Dahl's criterion that democracy depends upon "democratic beliefs and political culture" might well be broadened to include the notion that it is also dependent upon a majority of the population sharing the values of the Enlightenment, where society is ruled by institutions based upon the exercise of human reason as applied to contemporary circumstances, rather than upon strict interpretations of ancient texts, religious or otherwise. Inherent in this idea is the notion the ultimate judgments about right and wrong are to be made by citizenry in light of contemporary circumstances, comparable to the role of juries under English law.

While Dahl lists the establishment of a market economy as being a desirable but not essential circumstance, he and other authorities note that there have been no democracies outside of market economies. He also notes that a democracy can take central control of its economy for a short period in wartime, as an exception to this rule. This necessity of a market economy as a prior condition may seem surprising, but it will appear much more reasonable once we have a look at European and American experience in the period 1400–1800.

Favorable Conditions for the Maintenance of Democracy

Merely establishing a democracy is not the end of the developmental challenge. There are some favorable conditions for its continuance as well. Dahl does not make a list of such conditions for the maintenance of democracy, but two such conditions are implicit in his text. I have added six more conditions, each of which merits a few words of explanation:

Dahl's implicit conditions

1. Avoidance of excessive inequalities in the distribution of wealth and/or economic power
2. A broadly shared awareness that laissez-faire capitalism can be expected to generate income inequalities that, if not corrected, can be expected to become incompatible with democracy[36]

   My addendum
3. A system of checks and balances on the use of state power
4. A strong, well-mobilized middle class
5. Limits on political spending
6. A code of ethics requiring that individual self-interest be balanced against the responsibilities of citizenship
7. Adequate revenues for the state to finance basic public goods and services
8. No large source of unearned income (such as oil or other mining royalties) that can be captured by a political faction through its control of government

Inequality beyond some point is incompatible with maintaining democracy, not because unequal consumption of consumer goods is unjust, though it may indeed be, but because gross inequalities imply the possibility of converting economic power to political power and abusing one if not both forms of power, i.e., corruption of the system. This is the conflict implicit in Dahl's notion of antagonistic symbiosis. Unequally distributed political resources undermine the doctrine of political equality, which is democracy's bedrock.[37] The conversions of economic power to its political counterpart is by definition undemocratic; it permits an oligarchy to exercise undue influence that is the antithesis of government by the people and still more for the people. However, it is not easy to specify at what point in which metric one has "too much" inequality. The Gini coefficient is quantifiable and therefore comparable across countries as well as time, but it is essentially a proxy for the relative power to consume. Inequality is a much more serious problem when it corrupts the opportunities to earn or to vote, thus challenging the very legitimacy of both capitalism and democracy.

Given the potential illegitimacy associated with inequalities of power in a capitalist society, it is very favorable to have broad public awareness that capitalism can be expected to lead inevitably to a certain measure of inequality which, if left unchecked, would permit a wealthy and powerful elite to move from polyarchy toward oligarchy. Public awareness of this risk should include the recognition that free markets are not likely to correct such a situation; indeed they are likely to accentuate it. Some form of public intervention is required, a point developed in a recent special article in *The Economist*.[38] I will have more to say about these circumstances as we proceed, as they are a central thrust of the analysis.

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[36] Dahl, *On Democracy*.

[37] Robert Dahl, *Democracy, Liberty, and Equality* (Oslo: Norwegian University Press, 1986), 10.

[38] "Special Report on the World Economy," *The Economist*, September 16, 2006.

Given that there is a well-established scholarly literature to the effect that the central problem of democratic governance is limiting the powers of the sovereign, the third criterion enumerated above, the first of my list, merits a fuller explanation. In this established perspective "the fundamental political dilemma of an economy [is that] any government strong enough to protect property rights, enforce contracts, and provide macroeconomic stability is also strong enough to confiscate all of its citizens' wealth."[39] A ruler who has the powers to protect and regulate the economic activities of his subjects also has the power to usurp control and overturn democracy or to prevent its establishment in the first place. How, then, can one establish or maintain the limited powers of government assumed in a democracy? The idea is to limit the likelihood of abuse through the creation of mechanisms, as North, Summerhill, and Weingast posit: "For political officials to adhere to a set of citizen rights under the consensual basis of [political] order, these rights must be self-enforcing."[40]

Implicitly this answer assumes that some citizens have power, and enough to topple an incumbent government if it violates the terms under which it governs. This happened in 1215, when, at the insistence of his nobility, King John of England signed the Magna Carta, which "limit[ed] the Crown as dominus but [upheld] it as rex," emphasizing legality over royal caprice.[41] This concept of limited monarchy was subsequently enforced by the trial and execution of Charles I in 1649 and again by James II's forced flight out of the country in 1688. William and Mary accepted far greater restrictions on their powers as a condition for assuming the crown in 1689. In a similar vein, the framers of the US Constitution made sure to enumerate the powers of the federal government relative to those of the states and those reserved to the people, as well as the respective powers of the three branches. Based upon lengthy negotiations in Philadelphia in 1787 and subsequent ratification by special state conventions, the Constitution replaced the much weaker Articles of Confederation.

In each of these examples, the citizens who negotiated these agreements had great power at a key moment in time, and from thence forward they and their successors had much to gain in terms of peace, stability, and prosperity from keeping their respective sovereigns in check. When that consensus in the merits of the agreement broke down, there were repercussions, as on the eve of the Civil War in the United States, when the south seceded and war ensued. In that instance, a constitution that had appeared to be a self-enforcing agreement turned out not to be so in the face of a conflict over the right to perpetuate and expand slavery.

Another way to frame this issue of constraining the powers of government is to consider how government officials can be held accountable for their use of power

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[39] Douglass C. North, William Summerhill, and Barry R. Weingast, "Order, Disorder and Economic Change: Latin America vs. North America," draft chapter, September 1999, 6, http://www.stanford.edu/~weingast/north.summerhill.weingast.8.05p.pdf.

[40] Ibid., 9.

[41] S.E. Finer, *The History of Government from the Earliest Times*, vol. 2 (Oxford: Oxford University Press, 1997), 905.

over time as some individuals, firms, and interest groups gain relative power. If there is an oligarchic distribution of private power, it can become so unequal that government officials end up doing the bidding of unelected citizens, and the regime governs for a few—instead of all—of the people. In this alternative perspective, the central question might be how to empower the citizenry to demand that the powers of the rich be limited; upper limits on the concentration of wealth and power thus seem to be a necessary condition for the continuing existence of accountable government.

As criterion four indicates, a large and effectively mobilized middle class contributes to a democratic government's capacity to legislate in the interests of society as a whole, rather than in the interests of powerful elites. Legislative decisions will then more or less appropriately reflect the costs and benefits accruing broadly to society rather than to narrow, special interests, as discussed in the previous chapter. Furthermore, there must be effective limits on political spending in order for the legislature to represent the middle class and not just a well-heeled and well-organized set of special interests. Here political institutions matter, both those that shape elections and those that shape legislative processes. Requiring that all legislative business be transacted in the open, where the press may be present, makes the process more transparent, but it also makes it more susceptible to the influence of lobbyists. Thus, as criterion five states, limits on political spending facilitate political equality among citizens.

Moving to criterion 6, whatever the rules of a society, there is reason to question whether any formal rules or structures can constrain human creativity if the individual's internal compass is uniquely oriented toward the north star of self-interest. Whereas traditional societies (pre-1800) had trading relationships that were largely within a radius of perhaps 10 miles, except along the water, and thus a sense of community interests as well as individual interests, the transport revolution vastly enlarged that trading radius and reduced the sense of community, while the decline of religious authority reduced internal restraints on the pursuit of private advantage. The implications were profound. As historian James Kloppenberg writes: "for nineteenth century Americans self-interest displaced self-discipline as the central cultural value. Democracy . . . came increasingly to mean only the unbridled pursuit of wealth and power. . . . Only religion or authority could check the materialism of people obsessed with getting ahead, and both were increasingly vulnerable."[42]

Private pursuit of self-interest can induce productive behavior, but also nonproductive predatory behavior, even in a developed country. If a society's internal ethic becomes "take all you can get," no set of institutions is likely to contain the temptations for cutting corners for self-interested advantages. Freedom in such a context becomes a license to plunder others by first changing the rules or persuading the appropriate authorities to abandon their enforcement. To this end, I have noted the importance of a code of ethical citizenship as criterion 6. I elaborate on

[42] James T. Kloppenberg, "Democracy," in *A Companion to American Thought*, ed. Richard Wightman Fox and James T. Kloppenberg (Oxford: Blackwell Publishers, 1995), 174.

contemporary examples of this criterion, or rather on its absence, in the final two chapters of the book.

Governments in developing countries face all the problems noted above plus the possibility of failure to generate adequate revenues to meet essential responsibilities,[43] as cited in criterion seven. A government that is unable to raise adequate funds to finance such basic public goods as schools, law enforcement, and physical infrastructure lacks the basic prerequisites for effective governance, democratic or otherwise. In addition, it lacks the resources to assure that its least fortunate citizens have the powers to enjoy whichever freedoms they may theoretically be entitled to. A citizen without an effective education and effective legal protection has been deprived of the right to develop his or her abilities as well as the right to enjoy the fruits of his or her labor. Countries with very unequal incomes can have trouble taxing their rich citizens, as their governments may not have the capacity, either political or administrative, to require the rich to pay direct taxes on property or incomes. As a result, such governments must rely upon indirect taxes such as sales taxes, taxes on imports and/or exports, and excise taxes on luxuries, perhaps including gasoline. Reliance on indirect taxes is likely to mean both high reliance on regressive taxation and low tax collection overall, in order to minimize the take from the poor. While a low tax environment may be supportable and expedient in the short run, it is likely to be a very debilitating circumstance if pursued long term. Despite a good deal of rhetoric to the contrary, successful democracies have been characterized by relatively high levels of government spending. The United States is at the low end of this range, among democracies and among all countries in general.

As my eighth and final criterion, I would add that the absence of a large source of unearned income is very desirable for any developing country. The existence of any such source of income makes the capture of government an obvious way for an elite group to amass wealth and use the windfall revenues to maintain its power, financing a patronage system that could be the basis for long-lasting and undemocratic control. Endemic intimidation and corruption would naturally follow.

The conditions listed above as integral to the establishment of democracy should raise questions about how rapidly and satisfactorily many developing countries can expect to progress toward a liberal or law-abiding version of democratic governance. For instance, while Freedom House lists Indonesia and Nigeria as having elections that can bring a change of power, these elections may still leave these countries a very long way from an effective democracy that governs for the people. Venezuela has recently elected and re-elected a former army officer who has secured quasi-dictatorial powers by constitutional means, much as Hitler did in the 1930s, and there could well be other Latin American examples in years to come. Elections—at least, legitimate elections—are a good indicator of government by the people, but no guarantor of government for the people.

[43] See Jeffrey D. Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin Press, 2005).

The second list of eight conditions for maintaining democracy should raise questions about the likely universality of the democratic model. Democracy has formidable challenges to meet in the process of becoming established and in achieving satisfactory implementation. It could well meet a number of reversals as the process of globalizations creates additional economic inequalities within counties despite rising average incomes.

Overall, these two lists highlight the complexities of establishing and maintaining any democracy. The establishment of a constitution and the practice of regular elections are very important, but they are procedural aspects of making democracy work. They are not a substitute for meeting the preconditions noted above, nor are they any guarantee that the conditions for continuing existence will be met. Taken together, these two sets of conditions should make us aware that the world's apparent readiness for democracy belies the challenges of its installation and maintenance. While globalization will be supportive of democracy through its facilitation of rising incomes, it will also be an antagonistic force due to its tendency to increase intra-country inequalities based upon differing skill levels as well as upon tilts of resources toward capital relative to labor.

The foregoing considerations could be of considerable utility in assessing governance options in a post-conflict situation. A country's situation could be rated, e.g., from one to ten, in each category. With this approach, it would be quite appropriate to estimate a total score for any such country, and then to compare it with similar scores from post-conflict situations that have been met with varying degrees of success in order to consider whether the country is ready for democracy.[44] A country whose governing authorities did not have a monopoly of coercive force, for instance, would be seen as a poor candidate for a democratic transition, and attention would be focused on achieving such a monopoly as a precondition. Achieving a monopoly of coercive force would require sufficient resources to finance an adequate ministry of justice, police force, court system and prisons, and in a post-conflict situation this might necessitate considerable amounts of sustained foreign assistance. Laying the groundwork for democracy might also imply certain freedoms and institutions created by capitalism; below, I continue with my inquiry into the relationship between democracy and capitalism.

Democratic Capitalism

Since democracy appears to depend upon the decentralized economic markets of capitalism, and since large-scale capitalism historically comes first, it is important to consider how these two systems co-exist and influence each other. I find it useful to conceive of democratic capitalism as consisting of two subsystems that are intimately intertwined yet based upon quite different internal dynamics. The capitalist

[44] Obviously it would be dubious to sum the scores in different dimensions, but approximate scores still might be valuable.

subsystem consists of three levels: political, administrative, and economic, as discussed in the previous chapter. The political subsystem also consists of three levels that are parallel in structure, as suggested in Fig. 2.4.

The political system governs far more than the economy, including national defense and the provision of a variety of social services. But, as we have seen, it shares its ultimate governing force; it is a political authority—and not the economic markets—that establishes and legitimates the institutional framework of capitalism, including its physical and social infrastructure as well as its rules and regulations. This political authority is then held accountable for the discharge of these responsibilities by the political markets alone, a crucially important distinction. The political markets must be so structured that the two-stage competition entailed in elections and legislative activity yields legislation that takes appropriate account of true social costs and benefits, ensuring that results will be "for the people," in Lincoln's terms, and not primarily for a rich elite or a poor mob. How is any such outcome to be approached, let alone achieved?

The moral theory of democracy is based upon equality among people, meaning that voters should have equal political rights. But this is not the principle followed in economic markets, where consumers are not treated equally because they do not have equal amounts to spend in the economic markets, i.e., they have unequal purchasing power. Are consumers to be weighted according numbers or wealth? If it is to be the former, then what restrictions are placed upon how they use their wealth to influence political markets, i.e., elections or the markets for legislation? Despite the fact that each person may have only one vote at the polling place, some members of the polity are sure to have far more power than others, and economic power can be converted to political power, through, among other methods, lobbying, campaign contributions, or bribery. How great can the differences in political power be in the electorate without making a mockery of the notion of democracy?

Democratic capitalism faces a conundrum. The inequalities that are the essence of the capitalist system can be transferred to the political system. A rich person can mobilize an organization to get out voters who are thought to have the right voter preferences; a poor person cannot really compete on these terms. Should the political rights of the rich be limited in some ways, to make them more nearly equal with those of the poor? Is there a societal interest in limiting nominally free but essentially paid political speech? If one of the benefits of capitalism is reducing governmental interference in the economic realm, should there be a corresponding principle of limiting the influence of capitalist wealth in the political realm?

Who is to say? Some would say that democracy is first and foremost a system for protecting individual freedoms. Others would favor the rights and freedoms of society as a whole. Milton Friedman stands as a well-known example of the former libertarian principle, holding that any curtailment of individual freedoms by government effectively serves to curtail not only basic human rights, but also to thwart the freedoms that are necessary if extraordinary people are to facilitate capitalist innovation. Acknowledging that the "relation between political and economic freedom is complex and by no means unilateral," Friedman argues that private power serves to check governmental power and offers "effective protection of freedom of speech, of religion, and of thought."[45] While true in considerable measure, these same rights allow wealthy people to have above average influence on political processes, especially when the courts translate freedom of speech into the right to buy unlimited amounts of newspaper or television ads to reach a wider audience. In like manner, while cautioning against the concentration of economic power in the political system, Friedman ignores the possibly corrosive influence that private economic interests can have on the political process. Rather, he lauds the "role of inequality of wealth in preserving political freedom"—namely, the patronage of "a few wealthy individuals" (ignoring corporations) who bankroll "radical" political causes.[46] These wealthy patrons need not approve "the soundness of the ideas to be propagated"—they need only acknowledge that "the propagation can be financially successful" in the marketplace; thus, political ideas are submitted to the political market for approval, based upon using grossly different amounts of power from the economic markets, while seeming to ignore the grossly disparate means available to sell some ideas relative to others.[47]

Friedman argues that limiting governmental power serves protective and constructive ends—notably, the preservation of individual freedom and the advance of civilization. Civilization, in Friedman's mind, is advanced through the achievements "of individual genius, of strongly held minority views, of a social climate permitting variety and diversity."[48] Friedman concedes that government "could undoubtedly improve the level of living of many individuals . . . [and] the level of performance in many local areas and perhaps even the average of all communities."[49] But he views such uniform uplift as "stagnation" rather than "progress," or as the "[substitution] of uniform mediocrity for the variety essential for that experimentation which can bring tomorrow's laggards above today's means."[50]

Furthermore, while recognizing that government is essential to making, enforcing, and modifying the rules, Friedman effectively treats government as a black box, ignoring the nature of that government and the extent to which it is accountable to those that it serves. While Friedman maintains that economic freedom is a necessary but insufficient condition for political and civil freedom, in an appended 2002 Preface to his 1962 landmark publication, *Capitalism and Freedom*, he writes: "political freedom, desirable though it may be, is not a necessary condition for economic and civil freedom. Along these lines, the one major defect in the book seems to me an inadequate treatment of the role of political freedom, which under some circumstances promotes economic and civic freedom, and under others, inhibits

[45] Friedman, *Capitalism and Freedom*, 10, 3.

[46] Ibid., 17.

[47] Ibid.

[48] Ibid., 4.

[49] Ibid.

[50] Ibid.

economic and civic freedom."[51] Friedman's notion of freedom from coercion or domination is quite a different rationale for public policy than freedom of expression for one's views, backed by unlimited funds. The former is obviously consonant with and arguably essential to the practice of liberal democracy, while treating campaign contributions as tantamount to political speech—and deserving of identical protections—is an elitist justification of freedom for the rich, with little regard for egalitarian political rights.[52]

I believe it important to continually remind ourselves that economic power can be converted to political power, as suggested by Fig. 2.4, and that democracy can thereby be corrupted even if no laws are broken. Left unregulated, spending in political markets will affect political markets and then economic markets in due time. Business interests will have an incentive to contribute to political campaigns in order to improve their chances of more favorable regulation by government as well as additional contracts from government. Unregulated competition in political markets can in this way be a source for corruption of capitalism.

Antagonistic Symbiosis

Exposing the above flaw in Friedman's conception of political freedom (i.e., his oversight of the potential for economic power to buy political power and thereby relatively more "freedom") leads us to a discussion of the antagonism between democracy and capitalism. Capitalism and democracy appear at first sight to be mutually supportive or symbiotic systems, as we have noted. However, these two systems of governance have distinctively different internal logics and dynamics that become apparent through time, and thus their relationship is much less stable than it first appears. Democracy is premised on the notion of moral equality among individuals and the freedom of self-determination; inequalities beyond some limit become incongruous. Capitalism, on the other hand, is premised upon the notion of granting individuals economic freedoms to develop their talents and resources, as well as "the primary freedom of choice in the market place."[53] Though individuals are subject to governance through regulated forms of competition, those who excel in that competition receive higher rewards, which they are allowed to retain and build upon to achieve still further advantage. How can two systems based upon such differing premises manage to be mutually stabilizing let alone mutually supportive?

[51] Milton Friedman, "Preface," in *Capitalism and Freedom*, 40th anniversary ed. (Chicago: University of Chicago Press, 2002), ix–x.

[52] The US Supreme Court seems to have taken a position similar to Friedman in supporting paid advertising as free speech, as in *Buckley v Valeo*, 424 U.S. 1 (1976).

[53] Dahl, *Democracy, Liberty, and Equality*, 10.

Dahl, drawing on a remarkable biological metaphor, dubs the relationship between capitalism and democracy "antagonistic symbiosis."[54] He enlarges the scope of the symbiotic side as follows

> Many systemic features of an advanced market economy and society support the development and maintenance of democratic beliefs and practices. These include a stable legal system, considerable decentralization of economic decisions, wide use of information, persuasion, inducements, and rewards rather than open coercion to influence the behavior of economic actors, the creation of a middle class, access to fairly reliable information, and so on.[55]

Decentralized economic markets are a natural (i.e., symbiotic) context in which to develop the decentralized political markets of democracy. In such situations, crucial economic and political decisions are reached by the impersonal processes of market forces. However, this very process can also be a source of antagonism between the two systems of governance, as capitalism is premised on the possibility of cumulative gains, which exacerbate inequalities. Some degree of inequality or electoral antagonism is inevitable, of course, and desirable as a way to recognize skill and effort, but capitalist competition can increase the inequalities such that they come to profoundly influence the political system in ways that are blatantly undemocratic.

The antagonistic element of this relationship has changed through time, becoming exacerbated as new technologies have created opportunities for firms to exercise vastly more power and as larger markets have made the competition more impersonal. Prior to the Industrial Revolution, the oligarchs of capitalism were apt to be the landed aristocracy, the merchants, and the bankers. With the Industrial Revolution came the textile firms, the railroads, oil producers, steel mills, and other industrial firms. And since about 1980, and especially in the new millennium, the centers of power have switched relentlessly toward finance. The increased scale associated with these new technologies induced the creation of large firms that could take advantage of suppliers or customers and conceivably crush their competition. A railroad, for instance, could maintain near-monopoly conditions along much of its lines before automobiles and trucks arose as alternatives and was, under these conditions, able to quote different rates to different farmers, privileging one while disadvantaging another. At the limit, such monopolistic control could also disadvantage or destroy local firms, while commanding monopoly rents by favoring large firms.

If the containment of inequalities is critical to the compatibility of capitalism and democracy, then we should try to be as explicit as we can about the nature and sources of such inequalities as a precursor to considering approaches to measuring, comparing, and eventually containing them. I want to suggest that there are two kinds of economic inequality to be found in capitalist systems—benign and corrosive. They can be distinguished by the radically different causes from which

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[54] Dahl, *On Democracy*, 166.

[55] Dahl, *Toward Democracy: A Journey, Reflections 1940–1997*, 147.

they stem. Little systematic knowledge about either benign or corrosive inequality existed as recently as 50 years ago, and our knowledge concerning the more benign form may have advanced much more rapidly than our knowledge about the other, more corrosive, type. In the developed world, far more opportunities to corrupt the system for private advantage while staying within the law, rather than by breaking it, present themselves. Though illegality is a more obvious offense, corruption presents itself as a driving force of antagonism between capitalism and democracy. And yet, we have strong reason to believe that inequalities are inevitable and, in some forms, desirable. Is there a distinction to be drawn between good inequality and bad, or benign and corrosive, as I refer to them above? How do these inequalities affect development? The next section reviews the literature of inequality and development and works toward addressing these questions.

Development and Democracy

Simon Kuznets was a pioneer not only in the development of the national income accounting system, but also in the exploration of income inequalities. In his presidential address to the American Economic Association in 1954, Kuznets offered a bold hypothesis that linked income inequality to economic development. He hypothesized that incomes would become more unequal early in the industrialization process, as the incomes of the urbanites rose relative to those of the farmers, while this process could be expected to reverse later on as the agricultural sector declined in importance, diminishing the importance of this source of inequality.[56] In addition, he predicted that public policies could be expected to intervene, for example, through restrictions on the returns on capital, taxes on incomes, or government provision of income transfer payments, and thus tend to limit the divergence of incomes within societies. Kuznets's hypothesis has two important thrusts: (1) inequality would initially increase and then decrease in advanced industrialized countries; and (2) the driving forces of this shift would be differing relative incomes by sector, i.e., agriculture and industry or rural and urban. As he noted in his address, little data was available to support his claims. Kuznets's hypothesis is clear and bold: it sparked a plethora of valuable research and is still favorably cited.[57] Nevertheless, in subsequent decades it has been superseded, as the inequalities Kuznets hypothesized can now be identified more precisely, with some of the most extreme variations within sectors based upon hierarchical control of power, as suggested in Chap. 13.

The Kuznets hypothesis is very important for the thesis of this book. It describes a process whereby incomes will become more unequal in a naturally and essentially benign way. It does not ascribe them to explicit human agency, pernicious or

[56] Simon Kuznets, "Economic Growth and Income Inequality," *The American Economic Review* 45, no. 1 (March 1955): 1–28.

[57] See Edward L. Glaeser, "Inequality," Unpublished draft chapter for the *Oxford Handbook of Political Economy* (Harvard Institute of Economic Research, June 2005).

otherwise, or imply aggressive or predatory competition; indeed it does not imply any absolute loss, acknowledging only that farmers would experience a drop in incomes relative to urbanites.

At the other extreme—the extreme that captures the interest of my analysis—are inequalities of the type that come from agency. Consider a railroad granting preferential treatment to one customer relative to another, as, for example, with a differential rebate for shipping comparable goods a comparable distance in the era before the competition from trucks on good highways. The example of railroad competition, rather than being far-fetched, is emblematic of the issues that led to the emergence of railroad regulation in the United States; regulation was an avenue to limit the manifest abuses by these regional quasi-monopolies. In practice these abuses could be corrected through a regulatory regime that required comparable rates for comparable services and that set maximum rates to avoid monopolistic pricing as indicated by "abnormal returns" for the railroad. The example becomes even more interesting if we consider the linkage between the economic and political systems. Suppose the railroad lobbies to delay the establishment of a regulatory commission, and then lobbies to withhold any research budget from the commission, thereby preventing the latter from regulating rates because it is unable to assess the value of the railroad's assets, and hence unable to compute an estimated rate of return on those assets. In a hypothetical situation such as this, a railroad makes unusual profits, has unusual economic and thus political power, and is able to magnify its power through further lobbying of the legislature. Now we have an example of economic inequality that is corrosive, as well as an illustration of how the relationship between capitalism and democracy can be actively antagonistic.[58] We will have occasion to take note of just such circumstances in the United States in the last quarter of the 19th century in Chap. 13, and of the political battles for reform.

In a modern economy there are innumerable opportunities to actively fine-tune the regulatory frameworks, and these opportunities give great potential for advantages to powerful economic actors relative to those that are weaker. All of these conferred advantages may be legal; bribery need not be involved to gain special favors from government. There can be unethical behavior by regulators and business executives, or both, but there need not be overt illegality. The crucial point is that, while inequalities of power are endemic in a capitalist economy, they can remain largely unreported, except in extreme cases. These inequalities permit the use of persuasion, subtle or otherwise, and can take place out of sight. The resulting distortions of market frameworks will not normally be recognized in any published data. Thus, I would argue that the real inequalities in capitalism could be far larger than they are reported to be, and that they often occur to the benefit of lobbyists and others who troll the political waters for advantages for their clients, advantages which are parasitic and which distort markets. The more sophisticated and commercialized a system of capitalism is, the more of this kind of behavior one

[58]For an illustration of this process involving the Southern Pacific Railroad and the State of California, see Chap. 13.

might anticipate. We need to keep these issues of unreported and actively created advantages and incomes in mind as we conclude our discussion of inequalities.

Seymour Lipset was a pioneer in the study of inequalities and their relationship to democracy and development, but he relied largely on the reported data on individual incomes. Lipset initially found a symbiotic relationship between the rising incomes of capitalist societies and their political stability. However, subsequent work has pointed out that his analysis was based upon static snapshots at a point in time in various countries rather than upon a longitudinal study of the experience of individual countries through time. Developed countries looked stable; developing countries, much less so. But this was misleading.

According to one distinguished source, Lipset's work relating democracy to economic development "has generated the largest body of research on any topic in comparative politics. It has been supported and contested, revised and extended, buried and resuscitated."[59] Ignoring issues like income distribution, Adam Przeworski and Fernando Limongi Neto focus attention on Lipset's discussion of the narrow relationship between democracy and economic development, with development gauged according to per capita income. Przeworski and Limongi Neto evaluate endogenous and exogenous versions of Lipset's link between the level of development and democracy. The endogenous explanation asserts that economic development spurs democratization, with democracy emerging as the end product of modernization. With this model, "the sequence of events one would expect is one of poor authoritarian countries developing and becoming democratic once they reach some level of development, a 'threshold.'"[60] Przeworski and Limongi Neto dismiss an endogenous relationship on the basis of data demonstrating that, while "transitions [to democracy] are increasingly likely as per capita income of dictatorships rises," this correlation disappears when per capita incomes reach a certain point, above which "dictatorships become more stable" and transitions more unlikely.[61] They conclude: "the causal power of economic development in bringing dictatorships down appears paltry."[62]

Having established that development does not cause dictatorships to give way to democracies, Przeworski and Limongi Neto turn to the exogenous explanation linking democracy to development, which posits that development fosters the survival of potentially economically independent democratic regimes. They find that "during the period under our scrutiny or ever before, no democracy ever fell, regardless of everything else, in a country with a per capita income higher than that of Argentina in 1975: $6,055," thus demonstrating that "once established, democracies are likely to die in poor countries and certain to survive in wealthy ones."[63] Przeworski and Limongi Neto thereby reject the endogenous, "deterministic" explanation of

[59] Adam Przeworski and Fernando Limongi Neto, "Modernization: Theories and Facts," *World Politics* 49, no. 2 (1997): 155.

[60] Ibid., 158.

[61] Ibid., 158–159.

[62] Ibid., 165.

[63] Ibid., 165, 167.

democracy emerging as a "by-product of economic development," finding, instead, that "Democracy is or is not established by political actors pursuing their goals, and it can be initiated at any level of development."[64]

When and Why Is Inequality a Problem?

Przeworski and Limongi Neto's elegant analysis employs a simple, dichotomous classification of democracy, focuses narrowly on the relationship between democracy and per capita income, and dismisses modernization theory. Edward Muller's assessment of Lipset's work takes up the process of modernization and focuses on the role of income inequality in this process. Muller reasons that Lipset's analysis implied a situation in which the level or quality of democracy should improve as incomes rose.[65] But when Muller evaluates the data for the 1960s and 1970s, he finds that "economic development or 'modernization' tended to be associated with *declines* in democracy," at least when one confined the survey to low- and middle-income countries.[66] For the higher income countries, the relationship between increasing incomes and stable democracy remained valid.

Muller argues that income inequality appeared to have a negative impact on the process of democratization as opposed to democracy itself, and he hypothesizes a connecting link: "the process of economic development initially exacerbates income inequality, which may explain the declines in levels of democracy in moderately developed countries."[67] He reasons that, while "the process of capitalist economic development is expected to have a positive impact on democratization because it produces a shift in the labor force from agriculture to industry and services" and "fosters the inauguration of democracy," the process "also initially heightens income inequality in a country, and this is expected to have a negative impact on democratization because a high level of inequality radicalizes the working class . . . and reduces the tolerance of the bourgeoisie for political participation by the lower classes. Therefore income inequality is incompatible with the stability of democracy over time."[68]

Muller's analysis is in this way supportive of Dahl's notion of antagonistic symbiosis. The competitive framework of capitalism will induce the commitment of human and financial resources in a continuing search for profit opportunities, leading to increased productivity and increased incomes. Simultaneously, this process can be expected to generate increased inequalities, and the cumulative nature of the latter will in time challenge the legitimacy—and long-term stability—of democracy.

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[64] Ibid., 175, 176.

[65] See Edward N. Muller, "Economic Determinants of Democracy," in *Inequality, Democracy, and Economic Development*, ed. Manus I. Midlarsky (Cambridge: Cambridge University Press, 1997).

[66] Ibid., 133. Italics original.

[67] Ibid., 134.

[68] Ibid., 137.

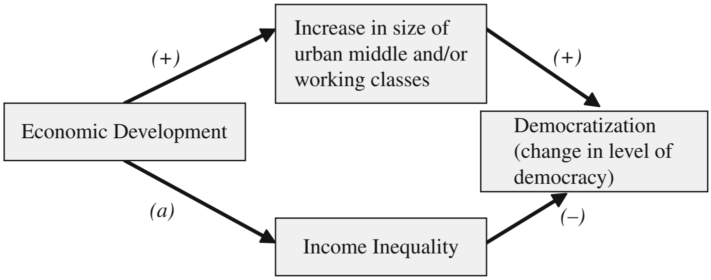

Fig. 3.2 Economic development, inequality, and democratization. Note: (a) represents an inverted U-curve relationship. Source: Edward N. Muller, "Economic Determinants of Democracy," in *Inequality, Democracy, and Economic Development*, ed. Manus I. Midlarsky (Cambridge: Cambridge University Press, 1997), 137, Fig. 5.1

Muller maps out the positive and negative connections between the two systems in a model, as shown in Fig. 3.2. He poses an "inverted U" relationship, as originally developed by Kuznets, between economic development and increasing income inequality, meaning that development for low- and middle-income countries was likely to be associated with increased inequality, which would in turn negatively affect the prospects for democratization, as shown in the figure. However, development for high income countries would be expected to be associated with higher incomes and no necessary increases in inequality, a contention Muller supports with an analysis of Gini coefficients and a second income measure for the period 1965–1980, and to which I will return.[69]

I find the work of Muller and Dahl a natural combination. As Dahl puts it, democracies have never been found in economic systems other than capitalistic ones. The extraordinary capacity of capitalism to facilitate the mobilization of human energy through a process of organized competition within markets is a prime force in the improvement in incomes and human welfare, and supportive of democracy. But the motivational power of competition depends upon the fact that consumers reward preferred suppliers with their business and, accordingly, reward the winning suppliers more than the losers. With respect to democracy, this essential dynamic of differential rewards is both a positive force—yielding increased productivity and attracting additional resources in a process that is supportive of democratic development—and an antagonistic force—yielding inequalities of income that are likely to be cumulative and thus at some point destabilizing unless reduced by public intervention.

Muller's analysis points to a complex and promising linkage between development, inequality, and the process of democratization. However, for this preliminary analysis, the real issues of inequality appear to be more political than economic, because it is political inequalities that are inherently undemocratic. While economic inequalities can be converted to anti-democratic political advantages, political

[69] Ibid., 141.

inequalities can persist even in the absence of large economic inequalities. This volume contains an example of just this phenomenon, in Bosnia, in the section on one country-two systems. In post-conflict Bosnia, local mayors could extort payments ("taxes") from merchants and use a portion of the proceeds to finance their political ambitions, a situation referred to as a patron–client relationship. The patron (mayor) may have the power to intimidate or physically harm a client and thus to extort money or political support for himself, a political faction, or party. I will consider much larger-scale examples of these patron–client relationships in the chapters on the Italian Mezzogiorno and on the US South. In each case, the political inequalities were far more undemocratic than one would expect from the underlying economic structure, though there is little precise data on that structure.

Throughout this discussion it is important to remember that some economic inequality is inevitable and indeed desirable in a capitalist society. Inequalities only become a problem when they become so great as to (1) threaten the legitimacy of the institutions of capitalism; or (2) become incongruous with stable democratic governance. Can either of these thresholds be specified in such a way as would indicate a tipping point?

Inequalities are often examined in terms of the distribution of income and/or wealth. This approach is, in my view, valuable but limited, inasmuch as it fails to capture some of the most essential aspects of inequality as it affects either the legitimacy of capitalist institutions or the likely stability of a democratic regime. Incomes measure market-based outcomes only within a given institutional context.

Certainly, inequalities in income imply inequalities in political resources and power, which pose a continuing challenge for a democracy. What measure of inequality should we use to monitor this challenge, and how much inequality is too much? There are no hard and fast measures of the point at which income inequality exerts deleterious effects on political outcomes. Furthermore, political inequalities can persist in the absence of wealth or income inequalities. Ultimately, the real issue for the congruence or instability of capitalism and democracy is political power, but having additional power does not automatically guarantee that it will be abused. Intent is required, and opportunity to abuse others at little or no risk of adverse consequences. Law enforcement agencies and courts are designed to serve as a bulwark against the abuse of power, whether by public agents or private, but how they work is a subtle matter. These very agencies may in fact be corrupted by elites such that they are more part of the problem than the solution.

Such abusive behavior can be restrained by public exposure, specifically when the media have the capacity and the mandate to unearth and expose abuses of power. As Larry Diamond has noted, "an independent, pluralistic mass media" is an integral component of "the cultural and civic infrastructure of democracy."[70] Indeed, Dahl lists "Alternative sources of information" as a requisite political institution in large-scale democracies, specifying

[70] Larry Diamond, "Promoting Democracy," *Foreign Policy* 87 (Summer 1992): 26.

> Citizens have a right to seek out alternative and independent sources of information from other citizens, experts, newspapers, magazines, books, telecommunications, and the like. Moreover, alternative sources of information actually exist that are not under the control of the government or any other single political group attempting to influence public political beliefs and attitudes, and these alternative sources are effectively protected by the law.[71]

The effectiveness of the investigative power of the media to expose and thereby allay certain politico-economic inequalities is neither uniform nor necessarily positive. The investigative powers of the media hinge on its ability (1) to afford the necessary costs of investigative reporting for original stories and (2) to withstand pressure and the negative consequences of publishing unfavorable information on influential people or organizations. Many newspapers have too little income to afford much by way of investigative journalism; it takes funds to hire journalists with the requisite skills and a news gathering budget to permit them the time to gather the necessary data. But beyond this, aggressive reporting can lead to losses in advertising income that may force a cutback or may even force the sale of the franchise. Even the threat of such advertising cutbacks can effectively neuter the investigative role of the media. When the media is neutered, society loses a check on the abuse of power. In a democratic society, citizens depend on media to provide information and to create the political demand for enforcement, providing a mechanism to publicize and then correct violations. Dahl's emphasis on access to and availability of alternative sources of information highlights the careful balance that must be maintained in news sources, with neither the government nor a single group controlling information.

In the United States, media "are not only among the freest in the world, they are also among the most commercial."[72] The "vast majority" of news organizations are profit-seeking and privately owned and, since the 1900s, the media has operated as an adversarial "fourth branch," acting as a check on the three branches of government while highlighting and augmenting political conflict.[73] However, the American example also suggests that commercial aims may undermine the press's role as a watchdog and political mechanism, as profitability competes with journalistic responsibility. Robert W. McChesney, a prominent reformer, argues: "The commercial basis of US media has negative implications for the exercise of political democracy: it encourages a weak political culture that makes de-politicization, apathy and selfishness rational choices for the citizenry, and it permits the business and commercial interests that actually rule US society to have inordinate influence over

[71] Dahl, *On Democracy*, 86.

[72] Thomas E. Patterson, "The United States: News in a Free-Market Society," in *Democracy and the Media: A Comparative Perspective*, ed. Richard Gunther and Anthony Mughan (Cambridge: Cambridge University Press, 2000), 244.

[73] Ibid., 250–252.

media content."[74] Certainly the commercial basis of US news media raises questions about its objectivity, as US companies become increasingly driven by considerations of producing short-term shareholder value.[75]

Freedom of choice in economic markets means that some economic actors will reap far higher rewards than others, if for no other reasons than unequal abilities and motivations. And because capitalism, unlike sports, has a cumulative scoring system, advantages can be passed on to the next generation, i.e., through access to better schools and other opportunities; thus, what one generation may earn for itself the next may inherit, in a pattern that reduces mobility. This allows winners in economic competition to amplify their political voices, and to wield more political influence than their presumed equals. Similarly, winners can use the informal powers conferred by their position in the capitalist system to distribute favors and amass political power in familiar patron–client relationships. Those who evaluate capitalism largely in terms of personal freedom (e.g., Friedman) appear not to see problems with its potential to contribute to cumulative inequalities over time. In my view this is where the real tipping point is to be found in the tensions between capitalism and democracy, i.e., at some point unequal economic and political power, created by capitalism, become incongruous with democracy, however, well those largely inherited advantages may fit with the freedoms of the lucky winners in capitalist competition. The analogy between organized sports and organized capitalism can thus be very misleading on this crucial issue: wealth and power can be accumulated indefinitely in the capitalist system, but not in that of organized sports.

For people who are less fortunate, support for a left-of-center government might appear to be a rational reaction to such inequalities. This pattern should be expected to lead to tensions between the haves and have-nots, tensions that invite corruption, coercion, and/or, in the extreme, attempts to overthrow a regime.[76] In this perspective, the fundamental cause of such corruption and/or instability need not be "bad" people or rent-seeking politicians or bureaucrats so much as the structural incongruities between the two governance systems that are "joined at the hip" to form democratic capitalism. As de Tocqueville pointed out in his treatise on *Democracy in America*: "Almost every revolution which has changed the shape of nations has been made to consolidate or destroy inequality."[77] Indeed, these battles over inequalities, which are produced by markets but only solved by human agency (or at least mitigated by it), can lead to the overthrow of governments, a pattern much in evidence in the last decade in Latin America, a region dominated by some of the most extreme examples of inequality in the world as we will see in Chap. 6.

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[74] Robert W. McChesney, *Corporate Media and the Threat to Democracy* (New York: Seven Stories Press, 1997), 7.

[75] For some discussion of this topic in the contemporary US context, see Chap. 14.

[76] See Muller, "Economic Determinants of Democracy," 135.

[77] de Tocqueville, *Democracy in America*, 2:611.

Conclusions and Implications

Capitalism and democracy have become the prevailing models of governance throughout the world, and the normative gold standard in their respective domains. While this makes capitalism and democracy appear to be a natural combination and an obvious choice for any society, the realities are more complex. Effective democracies are not easily launched: a number of underlying conditions must be met when establishing a large-scale democracy, before constitutions can be implemented or elected officials can take real power. An effective state, democratic or not, must be able to protect its citizens in order to govern effectively, and it must have a monopoly of coercive force in order to protect its citizens. Democracy cannot be expected to function in a normal way when in competition with armed, private militias. Furthermore, it cannot function without its own monopoly on the right to make, interpret, and adjudicate the laws; religious bodies that challenge this monopoly undermine this requirement. There are also requirements to meet if a democracy is to remain a healthy and legitimate form of government. While some of these requirements are obvious, those relating to the tensions between capitalism and democracy are easy to overlook.

Robert Dahl has pointed out that there is an antagonistic symbiosis between capitalism and democracy. Capitalism is based upon a Darwinian form of competition that can be expected to yield increasing inequalities as new technologies yield gains in productivity as these gains are captured by firms, and as these firms come to wield increased economic and political power. Ultimately much of this concentrated power is under the control of the managers of the large and/or powerful firms that are a natural product of capitalism. Democracy, on the other hand, is based upon what Dahl terms "the logic of equality."[78] Rising income inequality endows some people with greater political resources and thus far more legitimate power in the economic system than is implicitly legitimate in the political system. These systems, left to their own logics, can be expected to become incongruous and even incompatible.

One of the tasks of maintaining a democracy's capacity to govern for the people is to constrain those who amass undue economic power; another is to maintain constraints on the powers of political leaders who, with their legitimate control of the armed forces and the police, have the potential power to take control of the state and thus to subvert democratic government. To maintain its legitimacy, a capitalist democracy requires limits on inequalities in wealth and power, if only to keep the powerful from abusing their power by capturing still more. Chapter 13 illustrates how this balance can be corrupted if the private sector acquires sufficient power to subvert the public sector and/or society, and thereby subvert democracy, as happened in the United States late in the 19th century. Chapter 14 offers a second example, where the private sector took inordinate political power because of the decline in the powers of US democracy to effectively govern its own society, as I shall explain.

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[78] Dahl, *On Democracy*, 10.

Democracy offers the opportunity for people to mobilize (or be mobilized) to use the powers of the state to take advantage of common resources, including the legal framework. Chapter 14 offers an example of how a robust democracy could become corrupted by being weakened through superficially more open and democratic procedures. "More democracy" is not necessarily better unless it can be shown that the institutional frameworks of that democracy work for the people as well as through them. There is no necessary or obvious connection between the embrace of direct democracy by states, which allows a mobilized public to bypass state legislatures, and a system of governance that is more nearly for the people. The results depend upon having an adequately educated and informed electorate that understands what they are voting for and a set of institutions that bring out the votes in ways that approximate the composition of the population.

The same problem of "more democracy" may well be true in unduly opening the deliberative discussions of a legislature to the public. More openness in government, as in more transparency, may be like a disinfectant, but disinfectant should be handled carefully and not applied either in haste or in excess. Public perceptions can be easily manipulated in today's globalized context where issues are complex and time to study them very limited; sloganeering is not the same as governance. It is common to speak of market failures in capitalism; there should be more awareness that there can be political "market failures" in democracy as well, as illustrated by Italian failures to govern their Mezzogiorno and US failures to adequately constrain lobbying in the post-Watergate era, as we will see in Chaps. 8 and 14, respectively.

Given the ability of either capitalism or democracy to undermine the other, as well as succumb to market failures, inevitable tensions persist between these two systems of governance. Moreover, there can always be miscarriages between their intended and actual outcomes. As such, over the long run, the protection of freedoms for ordinary people depends upon successful governance in both realms, as well as upon successful intervention in both realms, when needed. Neither economic nor political markets automatically yield good governance. Good governance instead depends upon proper design and implementation of the institutional frameworks of their respective markets, and periodic monitoring to note deviances that merit correction. Appropriate institutional design depends upon the visible hands of human agents and not the invisible hand of an automatic mechanism.

Government must intervene to fashion and modify institutions if it is to limit an inevitable tendency for competitors in the two systems of governance to use their powers to accumulate still more power. Politicians can accumulate excessive power in their realm and then corrupt capitalism, just as capitalists can accumulate economic power in the capitalist realm and then corrupt the political system. Weak government opens the way for such abuse by both politicians and capitalists. Government must provide the public goods and services that permit ordinary citizens to develop their powers, i.e., "societal governance," thus providing a positive sort of freedom and enabling effective oversight of actors within both the political and economic realms. To deny the need for effective governance and/or to deny the existence of fundamental tensions between capitalism and freedom as well as democracy is disingenuous; it opens the opportunity for ideologues to subvert either or both of these systems.

Markets can be expected to create cumulative inequalities, and they cannot be expected to reduce such inequalities on their own. The logic of market liberalization, deregulation, and privatization thus is one of promoting growth while opening the way for increased inequalities through competition. It also opens the way for a secular decline in order in one or both systems, a decline that can lead to disorder and eventually to chaos. While the specter of rising inequalities might seem to come close to the circumstances that Karl Marx foresaw, they need not do so. Marx mistakenly believed that these dynamics would lead inevitably to long-term rule by property owners for their own advantage at the expense of their weaker neighbors. His oversight was in failing to recognize that governments have the capacity to moderate such inconsistencies, not once and for all, but with periodic interventions, through a combination of correcting market frameworks to take better account of true societal costs and benefits and through progressive taxation of those who are unusually successful. An effective democratic government should have the power as well as a natural incentive to attempt such corrective measures, provided that they are not corrupted by the actions of a self-serving elite.

It is government—and not economic markets or private economic actors—that can correct the excessive inequalities in wealth and power that undermine democratic capitalism. In Chaps. 8 and 9 I will examine two extensive case studies to illustrate the impotence of capitalism to overturn the abuse of power in imperfect democracies, one in the Mezzogiorno and the other in the US South. I believe that these examples will also show that democratic governments cannot meet their mandate to govern for the people unless they focus on the welfare of society as a whole as distinct from the freedoms or the self-interest of the winners in economic competition. The notion that peace, tolerable justice, and low taxes are all that is required of government for a society to move from barbarous circumstances to those of great wealth, as originally stated by Smith, was an extraordinary notion, which might have been appropriate for the atomistic capitalism that reigned in Smith's pre-industrial era. However, continuing affirmations of Smith's sentiments in the context of advanced industrial societies reveals a stunning oversight of modern capitalism's tendency to produce increased inequality alongside increased productivity and wealth.

At some point, inequality de-legitimates democracy, opening up a back-door route to oligarchy. In addition, inequality makes it increasingly difficult for government to raise the taxes needed to provide the goods and services for which it is responsible. We should expect government to meet its basic responsibilities to provide public goods and services of good quality in adequate amounts on a timely basis. At a minimum, this might include the provision of such basic infrastructure as roads, canals, a water supply, and, eventually, sewage. And we might also expect an effective system of laws, adequately administered and enforced, a good school system, and a good public health system. With these basics in place, all people can find some measure of opportunity in their respective societies and thus have reason to hope for a better future. This hope should help instill loyalty to the system, even for those whose lot in life is far from that of their richer neighbors.

A society's prospects for economic development depend in part upon government's meeting its responsibilities to see to it that adequate and reasonably priced public goods are provided in a timely fashion, if necessary by the public sector. In Chap. 4 we will explore why support for such a strategy is much easier in an egalitarian society than in an oligarchic one. Once the pattern of grossly unequal incomes and wealth becomes established it is very difficult to change, as subsequent chapters will demonstrate. Chapters 13 and 14, which analyze US capitalism and democracy after the era of atomistic capitalism had become a nostalgic myth, e.g., from the end of the Civil War onward, examine the possibility of inadequate governance in the name of deferring to markets, a challenge that endures in the present day. Our concern from here on is less with statistical inequalities as measured by the Gini coefficients or similar measures and more with inequalities of political power, whatever their source.

Chapter 4
Alternative Models of Capitalism

This book began from the descriptive perspective that capitalism and democracy are the two prevailing systems of governance the world over. Simple as that sounds, it masks the fact that the legacies of earlier, more centralized systems of governance remain. Indeed it is at least arguable that oligarchy is the prevailing condition in most countries, and that it continues to affect the distribution of political as well as economic power. These power relationships that lie behind contemporary societies may be out of sight to the casual viewer, yet, very real in their effects on contemporary life as well as on the prospects for future development.

In this chapter I propose to use some simple, stylized models, to illustrate how unequal and deep-seated power relationships, some of them pre-capitalist, were, and how resistant they could be to the spread of capitalism as well as democracy. Later I will take two chapters to show how persistent such relationships can be in modern democracies, through studying the stunted development of both capitalism and democracy in the context of two high-income democracies, the Mezzogiorno in Italy in Chap. 8 and the US South in the era of segregation in Chap. 9.

These comparisons are all affected by the analytic scheme for relating capitalism and democracy in the previous chapter where I noted that political systems are governed in part through a feedback loop, where those in civil society periodically have an opportunity to overturn their leaders through elections. At the same time I noted that there is no such bottom-up feedback loop through the capitalist system (Fig. 2.4). This asymmetry between these two systems of governance has very important implications. For example, it is a commonplace in economics to take note of the possibility of market failures in capitalism. On the other hand, it seems to me to be less common to recognize that those failures in economic markets must be corrected through the political process, for example, through votes in parliament. In addition, it is possible to have market failures in the political system, at least if the test of democracy is that it is to be *for* the people and not just *by* the people. What is one to make of these asymmetries (in powers) for self-correcting feedback, through the political system but not the economic?

Since my focus is on the evolution of capitalism, it is tempting to treat political systems as black boxes. Tempting as that solution is, I will not be content to do so in this analysis. In this chapter I want to use the three levels of political governance

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_4,

as a framework for analysis, at least to sketch out some potential failures in political markets, and to suggest how they could affect contemporaneous capitalism as power is transferred from one governance system to another. This is very important, because economic development implies changes in the structure of power in several dimensions at a minimum, for example, from rural areas to urban, from agriculture to industry, from producers to consumers.

To facilitate this analytic process of relating the two governance systems across changing circumstances, I propose a very simple framework for the identification and comparison of societal systems in terms of their underlying structures of property and power. While some forms of governance (e.g., oligarchy) cannot be wholly distinguished from the substance of the distribution of power (e.g., very unequal), I believe the latter can be broken down to reveal at least partial independence of the former (e.g., there can be great inequality of income and power in a democracy). I approach the challenge of assessing the effects of varying and potentially asymmetrical concentrations of economic and political power by first developing three archetypal structures of power relationships based initially on economic power, with the distribution ranging from highly concentrated to perfectly egalitarian. These archetypes are admittedly highly stylized and therefore imperfect models, but they do facilitate at least a basic understanding of societal development possibilities. Using these archetypes, I then consider how one particular power structure might be transformed into another. For instance, in what circumstances might a society with concentrated economic power be transformed into one where power is significantly less concentrated? Is this process likely to be driven by economics, politics, or both? In what circumstances might an egalitarian society arise?

I briefly delve into the details of such transformations to consider three questions. First, how might power shift both geographically and by sector of activity in the process of industrialization? Second, how might alternative structural arrangements that influence the locus of political power by function and by level (federal, state, local) be shaped to avoid excess concentrations of power? Third and finally, how might political systems intervene to limit distortions caused by the tendency for increasing concentrations of power to develop in the economy, and for some of that power to be transferred from the economy to the polity, thereby subverting the latter in those cases where the political system is democratic?

In using these three stylized models I recognize that I am not aware of any clear pre-determined tipping points for the transformation from one archetype to another. However, as a first step toward further classification, this chapter embraces the view of modernization ascribed to Przeworski and Limongi-Neto in Chap. 3, namely, one of human agency. This view is premised upon an anti-deterministic school of thought, in which "democratization was [and is] an outcome of actions, not just of conditions."[1] Successful democratization requires political leaders who can mobilize the power to counteract capitalism's natural tendency to promote an oligarchic power distribution. Alexis de Tocqueville recognized these relationships

[1] Przeworski and Neto, "Modernization: Theories and Facts," 176.

when he looked at European history as a background for his analysis of *Democracy in America* and observed that major revolutions were usually motivated one way or another by inequality—an attempt either to consolidate it or to destroy it.[2] Revolutions are led by actors who mobilize political power, not by impersonal forces inducing a new equilibrium in economic markets. I attempt, here and throughout this book, to anticipate and consider conditions and circumstances that may induce change while recognizing the primary importance of the actions that unfold on the stage of circumstance. Accordingly, subsequent chapters will expand upon the role of human actors by exploring specific historical examples of the scenarios highlighted in this chapter.

I begin the chapter by introducing the three archetypal models and basic ideas of how they are governed, in a quasi-static perspective in this first section. I then go on to consider some of the fundamental forces of societal development, such as the introduction of new technologies and new institutions and forms of organization. In so doing, I introduce the axiom that change is almost certain to be met with resistance, particularly from those who stand to lose, in relative terms. In Samuel Huntington's well-established framework for the analysis of the move from an agricultural to industrial society, modernization involves not only urbanization, improved education, and rising living standards, but also a shift in political power from rural elites to their newly empowered counterparts in cities. Building from Huntington's base, I suggest that the early examples of societal modernization included the possibility of a change in the system of governance from feudalism to oligarchy, with some possible exceptions that went straight to an egalitarian democracy. Then I continue the analysis by sketching what some of the implications of the egalitarian power structure might be in the development of governance and the provision of public goods. This analysis foreshadows some of the key questions explored in Chaps. 13 and 14.

Three Models of Power Relationships in Society

In conceiving of a spectrum of power relationships, I place a near monopoly of power by a single person or family at one end and a perfectly egalitarian distribution of power at the other end. The three archetypal examples offered here occupy the full range of a spectrum: one almost perfectly monopolistic, with all of the land owned by a single owner (e.g., the royal family); one egalitarian, in which all families have equal sized plots of land; and one which is located perhaps mid-way between these two poles. For the sake of brevity I will respectively refer to the three systems as feudal, egalitarian, and oligarchic. These models of the distribution and exercise of power will allow us to explore how capitalism and democracy might influence one another and, in addition, why there might be circumstances in which these two systems are incompatible.

[2] de Tocqueville, *Democracy in America*, 2:611.

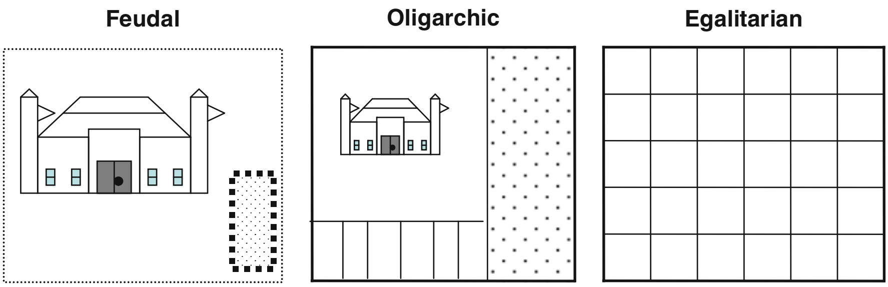

Fig. 4.1 Three models of the distribution of economic power. Source: Bruce R. Scott

In these diagrams, I use plots of land as symbols for economic power. Land was, in fact, a reasonable proxy for power in most of the world well into the 19th century, when farming was still the basic source of income for most people everywhere. Today there is no single form of wealth or power to use for such comparisons, but the idea remains useful nonetheless, and the plots of land serve as a convenient symbol here. As Fig. 4.1 suggests, the three archetypes are quite distinctive in an agricultural setting, though there are no hard and fast boundary lines between the respective models. In actuality, a society that is mostly governed in the feudalistic pattern might include oligarchic pockets, such as towns in which burghers enjoy freedom of movement and the right to change occupations. Similarly, a truly egalitarian model is so extreme as to have few if any real examples. At the same time, it does hold very considerable symbolic importance, as the notion of relative equality is widely used as an indicator of societal solidarity, a value very different from the individualism that has been so much emphasized in Britain and the United States. The egalitarian model has particular importance for this book in its study of US history; Alexis de Tocqueville found the United States to be the most egalitarian society then extant when he visited the United States in 1830, a judgment that has withstood more than 170 years of scrutiny. In addition he attributed the capacity of Americans to create their democracy to their relatively egalitarian structure of wealth and income, another insight that has stood the test of time. Since Europe at that time was being convulsed by conflicts between the forces favoring and opposing more egalitarian structures, I believe that this model would have been meaningful to him. And it is still meaningful today in the sense of providing a glimpse of just how different the United States was from any of the European countries in those crucial, formative years from 1600 to 1800.

Initially, it is useful to conceive of these models as operating on the small-scale of a township, county, or state and to defer the question of whether and how such models were applicable to nation states. Consider two model states or two regions as small as townships and reference the egalitarian and oligarchic structures of power to break down the ownership of land. While land, even good farmland, is not usually a central source of income, wealth, or power in today's circumstances, before 1900 farming was the primary means of earning a living for most people, even in the most developed countries. A thought experiment in this simpler setting helps us visualize how wealth can influence the development of institutions, and we can translate this experience into today's circumstances with many other kinds of wealth and power.

Suppose that all persons in this earlier agricultural context were free to own land and to move in search of better land, with unoccupied land available on the frontier. Suppose further that each parcel of land had adequate soil and rainfall for farming, that each farm could have a house on it, that each house was proportionate to the size of the owner's piece of land, and that each parcel was owned and inhabited by a family. In the egalitarian model, each plot of land might be equal to approximately 100 acres. The large plot of land in the oligarchic society might be about 1500 acres, and the small plots perhaps 2–5 acres each. The exact dimensions of the various plots are not important; the essential point is one of approximate size as an indication of approximate wealth and economic power. The standard landholding in the egalitarian model would be adequate to permit an industrious family to earn a good living in that earlier context, indeed it might well be about as much as a family could efficiently employ. In contrast, the small plots in the oligarchic model would likely be far too small to provide subsistence, even for an industrious family, while the large plot would grant a family considerable means and power, not to mention room for a mansion. In some cases the oligarch might own thousands of acres and live in a comfortable chateau assisted by servants, and the grounds might be surrounded by walls, with some of the servants patrolling the property in the role of guards. An even more extreme situation in terms of power may be surmised for the feudal model, where the small plots would be allotted to families for farming but essentially still owned by the family in the chateau.

What might we surmise about power relationships from these simple models of relative land distribution? As a starting hypothesis, we should expect that incomes from farming would be more or less equal in the egalitarian model, unequal in the oligarchic, and even more unequal in the feudal. We might similarly expect that wealth and economic power would be more or less equally distributed in the first, unequally distributed in the second, and quite concentrated in the third. Moreover, we might expect these patterns of power to persist indefinitely.

These simple power relationships, in turn, signal different political, economic, and social systems. Since the time of Plato, it has been customary to identify monarchy, oligarchy, and democracy as the three archetypal political systems. My classification aims to supplement this political designation with criteria for economic and social power. Thus, I put forth three models distinguished by three main criteria with "power" as a single, overarching category, as shown in Table 4.1.

I have added religion as a third system of power because, throughout history, several of the world's major religions have claimed to control the one true path to the benefits of personal salvation. In effect, these claims are an assertion of monopoly power, and it was not uncommon for this power to be associated with the right to punish or even to execute heretics. Thus, a strong religious authority was a natural fit with feudalism, and the decentralization of power in this dimension was supportive of both capitalism and democracy. For instance, in Europe the Catholic Church limited and also sustained the power of the monarch in feudalism, maintaining a role "in the feudal order, but not of it. [Typically the Church] exercised a wholly

Table 4.1 Three societal models

	Feudal	Oligarchic	Egalitarian
Distribution of property and power	Very concentrated, and expressed through non-market relationships	Unequal, but expressed in part through markets	Egalitarian; market or non-market
Political system	Monarchy	Oligarchy	Democracy
Economy	Self-sufficiency, no factor markets	Underdeveloped factor markets with very unequal power relationships	Capitalism, with ease of entry to factor and product markets
Religion	Universal church	Competing churches	Competing churches

Source: Bruce R. Scott

independent jurisdiction over a wide area of civil matters."[3] Obviously some societies were exceptional. Venice, a Catholic society, enjoyed an elected oligarchic government for more than a 1000 years, and pioneered capitalism well before 1400—a year commonly used for the emergence of capitalism as a system of governance. Venice, however, enjoyed unusual autonomy from "terra firma," or dry land, and even from Rome, having established the right to appoint its own bishops well before the year 1000.

Historically, feudalism was both a political and economic system. Under feudalism, monarchs, whether weak or strong, participated in a web of reciprocal relationships, incurring accountability to tenants.[4] The king or feudal lord owned land that was, in a manner of speaking, "leased" to a vassal in return for services, such as military service. Relationships were reciprocal, conditional, and non-market; the monarch in a feudal system governed through multiple levels of feudal relationships with smaller and smaller estates at lower levels. Politically, feudalism was "at once decentralized, polyarchical, and 'cellular,'" constituting "a complex hierarchy of patron–client relationships," wherein "political authority resides nowhere in particular because it resides everywhere."[5] Given this complex hierarchy, feudalism was obviously incompatible with democracy. But feudalism was also incompatible with capitalism. As explained in Chap. 2, capitalism implies that both capital and labor are free to search for their best returns in their respective markets. In feudal times, land ownership was restricted; it was typically transferred by marriage or inheritance, and therefore was not a resource that could be put to work for the highest income possible. And typically labor was not mobile either.

At the other end of the spectrum, the egalitarian model was an obvious setting for the emergence of democracy. An equal distribution of land implies an egalitarian distribution of wealth and economic power, and a similar distribution of political

[3]Finer, *The History of Government from the Earliest Times*, 888.

[4]Ibid., 864–873.

[5]Ibid., 867–868.

power. Such circumstances hosted the rise of democracy in ancient Greece as well as Scandinavia, including in Iceland, a society that was very poor but egalitarian for about a 1000 years prior to the 20th century.[6] Of course, the egalitarian model is also receptive ground for capitalism, with historical proof in the example of the colonial United States, as I discuss in Chap. 7.

Thus, one end of this continuum is incompatible with either capitalism or democracy, while the other is compatible with both. This makes the middle or oligarchic model extremely important. Unfortunately I have no way to be precise about the all-important oligarchic model. Oligarchy exists in many gradations, i.e., some oligarchies have a more unequal distribution of power than others, harboring subsequent gradations of asymmetries between the political and economic systems. Surely one of the most important questions to consider is how incongruous the power relationships can be in an oligarchy before a certain tipping point is reached, preventing democracy or capitalism. If economic power is held in the hands of a few, can there be democracy? If political power is held in the hands of a few, can there be anything that remotely resembles the voluntary, bilateral trade that Friedman refers to as the basic model of capitalism? Could there be any relationships that were not clouded by intimidation?

Limited monarchy, with its implied limits on the political power of the sovereign by a class of people holding considerable economic power, is a useful way to think about the normal form of government for oligarchy. In a limited monarchy, the king or duke needs the assent of his nobles or wealthy burghers in order to impose taxes and thereby fund his efforts to govern the realm. This implies the rule of law, as voted by a council or parliament, which in turn implies a context where property rights can be specified, with modifications from time to time through the parliament. Thus, this is a situation that is conducive to the establishment of capitalism. Obviously such a situation could be unstable, with an ambitious duke or king attempting to rule unilaterally, whether by inheritance or by divine right. Venice stands out again as a peculiarly stable example, where an oligarchy was ruled by a succession of elected dukes for more than a 1000 years. Florence and Genoa were also oligarchies in the Renaissance, and likewise among the earliest societies to experience the economic gains of capitalism, but their oligarchies were more unstable and were ultimately overthrown, replaced by despotism, and then taken over by a larger power. Both were able to remain capitalistic, but Venice outranked both in size and power. Despite the fact that Venice was based upon some very small islands with limited resources, it prospered, in large measure because its oligarchy was founded on a cluster of small islands that had come together voluntarily. Its dukes were accountable to its nobility, and accountable governance was its most formidable advantage for centuries. Two dukes who misunderstood their mandates were summarily executed as reminders for one and all of the notion of limited monarchy.

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[6] See Finer, *The History of Government from the Earliest Times*.

Development Implies a Transformation in the Structure of Power

Development implies rising incomes, which in turn imply a transformation in the structure of power. Very roughly speaking, development describes a transition from feudalism to oligarchy as economic power is decentralized both through political decisions and through the extension of rights to exercise economic power. Capitalism is based upon the formalization of these increasingly decentralized property rights and decision-making powers. This latter formalization can occur gradually, as guilds are allowed an increasing role in decision-making, or much more abruptly, when a regime is overthrown through revolution, and individuals are empowered to be independent economic actors.

Capitalism can further enhance development by establishing favorable conditions for democracy, but the Darwinian side of capitalism may threaten the egalitarian structure, and more rapidly and emphatically as industrialization progresses. We will have a remarkable instance of the latter in Chap. 13 when we consider US experience in the 19th century. However, if we start from the proposition that almost all present-day high-income capitalist countries were feudal in 1400, and that none are today, then we can infer that their development entailed a transition to oligarchic capitalism. The question then becomes, what shifts in power structure, income, and governance were required and how were they achieved? This is precisely where historian Richard Lachmann has focused his attention in *Capitalists in Spite of Themselves*.[7] This short chapter on theory is no place to attempt to prove anything as ambitious as Lachmann's work, but it does allow an opportunity to propose hypotheses. A first and crucial question is: How does a society transition from feudalism, with self-sufficiency supplemented by barter and a small amount of trade, to oligarchy, capitalism, increasing trade, and rising incomes?

The transformation of one power structure to another implies and, indeed, requires many related changes. I will illustrate some of these changes in brief in this chapter and in more detail in the chapters that follow. I begin with the feudal estate, the prevailing societal model at the beginning of the so-called modern era. In practice, feudalism involved pre-capitalist political relationships based upon reciprocal obligations whereby tenants were bound to the land and not allowed to move without the lord's permission, while the lord had certain obligations for their welfare. It was customary for the lord to provide a set of rules and expectations for his serfs, as well as a first level of courts for the settlement of disputes. Thus, feudalism involved strong vertical power relationships and a near monopoly of power at the manorial level. Since the serfs had little or no say in the governance of the manor, let alone in that of any larger jurisdictions, they had very limited political rights.

Feudalism also implied pre-capitalist economic relationships. The manor might have engaged in a limited amount of trade, perhaps relying on outside sources for such essentials as salt and luxuries such as spices or fancy cloth. These items might have come from long distances, because their weight-to-value relationship permitted

[7] Richard Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe* (Oxford: Oxford University Press, 2000).

movement over such distances. Overall, however, the feudal community was largely self-sufficient and self-governing. There would likely be a market in a nearby town, and it would be characterized by barter and/or traditional prices that were expected to be stable, rather than reflecting the vagaries of supply and demand. Aside from the fact that prices were not intended to reflect supply and demand, these local trading relationships might have been reasonably close to the bilateral voluntarism that Friedman extols in his definition of capitalism. As in his model, local suppliers would aim to achieve and maintain the trust of their customers through consistent quality and by refraining from charging higher prices in times of shortages (i.e., "unseemly exploitation" of adverse circumstances affecting the customer). If they sold poor quality merchandise (e.g., fruits, vegetables, or poultry) their reputation and future income would probably suffer.

However, in spite of the existence of voluntary trading relationships in feudal product markets, the two key factors of production—labor and capital—were neither free to seek maximum advantage nor mobile to change occupation in the case of labor, or ownership in the case of land. Wealthy landowners might own virtually all of the land but still not have the right to alienate large parcels; the latter might well be governed by laws of inheritance that controlled its movement from one generation to the next. Though quite different from today's production relationships, the relationships in the production sphere in the feudal economy were likely to be hierarchical, e.g., like tenant farmers, and in no way a model of freedom for any but the rich. Trade relationships are thus inadequate to describe this system or, as we shall see, any system. Production relationships are the key relationships that define an economic system, and production relationships are unlikely to be exactly equal given that economic agents rarely possess even approximately equal power.

As a system of governance, capitalism facilitates the mobilization of human energy through regulated competition, including the capacity to mobilize human, financial, and technological capital. Capital is not readily mobilized unless it is free to seek higher returns, much like the goods for sale in the market stalls. But for this to happen, the frameworks for the markets, for products as well as for capital, must be in place and enforced so that a deal or contract can in turn be enforced. In a poor country, where capital is very scarce, frameworks must shield potential investors from unnecessary responsibilities to the consumer, in the event that a product turns out to be faulty, hence the notion "let the buyer beware" as the basis for product liability. Creating such a legal framework would be pro-development, but at the cost of shielding investors and producers from liabilities that they must bear in this day and age. So this transition would require a more developed legal system, but not one that was necessarily consumer friendly.

The transition from feudalism to oligarchy involved a move in the direction of the decentralization of power, but power relationships could still be very unequal. Producers might have had more liberty to start businesses, yet might still be virtually immune from consumer complaints let alone lawsuits. Thus, in my view, oligarchy is broadly compatible with capitalism, a proposition demonstrated by the roughly 1000-year association of the two in Venice prior to 1800. However, oligarchy is not a natural partner for democracy.

Why would oligarchy be hospitable to capitalism? Under a limited monarchy, the sovereign and other powerful figures are subject to the rule of law, and the rule of law is crucial to capitalism. Oligarchy allows a council or parliament to serve as a problem-solving body, as suggested by Gabriel Almond in the previous chapter. Parliaments need not be democratically elected; even as elected representatives of one class, the wealthy, they can still reason together to try to improve the institutions of society. One of the first powers gained by councils was the right to authorize taxes to defray the costs of government. Once this process was institutionalized, the taxing powers shifted from the king to the parliament, and the credit of the country was based upon the credit of the parliament. It was a huge change, and would help bring down borrowing costs in England and the Netherlands in the 16th and 17th centuries. It would also help create a set of negotiable bonds to give elasticity to a monetary system, freeing countries from complete dependence on specie.

The enclosure and privatization of common lands was another such pro-capitalist act of parliament in England. It helped increase the rate of clearing and improvement of land as well as the productive maintenance and usage of such land, albeit at the expense of preventing many poor people from accessing them. Abolishing feudal land rights and permitting the sale of land had a similar effect, freeing up land for the use of those willing to pay more for it. Abolishing tariffs along inland roads was a means of stimulating trade, as was improving the roads. In addition, installing a clearly defined set of laws to govern property rights facilitated the growth of trade, including the extension of credit to facilitate sales.

Note that these examples of institutional improvements come through the political system, not the economic. And note that almost all of them favored producers as much as if not more than consumers. Would they have been approved in a democratically elected parliament? A rush to democratize might well have resulted in very different market frameworks that would have retarded capital investment and thereby delayed development. Thus, in these cases, economic development was very compatible with huge inequalities in wealth and income, and capitalism emerged long before democracy, notably in England.

Oligarchs have the capacity to exercise power through governments, run by the few primarily for the benefit of the few. Each of the institutional reforms such as improving roads or reducing tolls implies improved conditions for producers and traders, and only secondarily for consumers. Indeed the consumer might not benefit much in the absence of effective competition and an impersonal price mechanism that relates supply and demand. Economic and political oligarchy, as in a legislature where only the wealthy are represented, seems a perfectly viable proposition in terms of helping to establish capitalism and thereby to promote economic growth, but at a certain cost to society. These same oligarchs can exercise power through extra-parliamentary means at the same time, for example, by having their gardeners and other servants act as informal gangs to intimidate others. They can intimidate their neighbors in the hope of encroaching on their land or buying their labor at a lower price, for example, by restricting who may go into new lines of business. The usual term for such hierarchal, reciprocal, power-based relationships is "patron–client," where the oligarch is the patron.

Vertical or power-based relationships can also materialize in a more modern context where firms have market power, either in the form of predatory pricing for suppliers or consumers, or in the form of lobbying government for special favors at public expense. Thus, to focus on capitalism and freedom, as Friedman does in his model of bilateral exchange, while neglecting the structure of private power in the productive side of capitalism, is to ignore its hierarchical and potentially anti-democratic qualities. A strong state with an effective police force and judicial system is an essential bulwark to protect its citizens from the extrajudicial power exercised by the oligarchs who control the disposition of productive resources. A weak state leaves citizens at the mercy of oligarchs who, if given the freedom to do so, will act like predators. Government is not a unique source of abuses of power, as we will see in a number of the case examples, including the US examples of both the north and south in the 19th century.

Oligarchic intimidation of others and, at the extreme, domination of others, is the crux of the incongruity between oligarchy and democracy. Unequal wealth is a good indicator of the potential of a few to abuse others, but it is not the only such indicator, nor is the possession of unequal wealth a definitive indicator of the likely use of that power to intimidate or dominate. The real incongruity of oligarchy and democracy comes from the illegitimate use of power—economic, political, or religious—and not just its existence. I believe the crucial issue with regards to freedom is not illegality, but domination and corruption—either by the state or anyone with extralegal power.[8] While illegal behavior is always cause for concern, small scale illegality in the sense of public employees demanding bribes for performing their duties, as, for example, a baggage handler at an airport, is annoying but not very important. Large-scale extortion of bribes for government contracts is a different matter. But many forms of corruption represent an abuse of public trust that is sanctified by law at the request of private parties, as, for example, when oligarchs persuade a legislature to abolish regulations on environmental pollution or to water down the safety regulations on pharmaceuticals so that consumers can enjoy the full benefits of unfettered private enterprise, with pollution and dangerous products included. It is this corruption—permitted through the legal frameworks—that concerns me here.

Capitalism only works to serve the public good when the market frameworks take appropriate account of societal costs and benefits; if they are distorted for the benefit of powerful oligarchs, including powerful lobbies, they represent the bending of the system for the corrupt gains of a few. But as societies gain increasing wealth and well-being, priorities can be expected to change in the direction of providing additional safety and predictability to the lives of consumers. While Douglass North speaks of the evolution of market frameworks, this evolution is unlikely to be accomplished spontaneously, like the equilibration of supply and demand; it is likely to require legislating appropriate changes in market frameworks through a system of political markets, e.g., a legislature. Neither the timing of the changes, nor their magnitude, is a matter for scientific determination; these are the political choices of political economy.

[8] See, for example, the writings of Ian Shapiro.

Some Dynamics of Societal Development

Development is a complex process, encompassing social, political, and technical elements, as well as economic ones. Historically speaking, it has entailed a transformation from an agricultural society, typically dominated by rich landowners surrounded by poor, ignorant, passive farmers, to an urban, better educated, more diversified, and wealthier society that will eventually be characterized by more politically active citizenry and perhaps by democracy. This process of urbanization entails the adoption of new ideas and new technologies as well as the modernization of institutions. While such a transformation affects both the trading relationships and the productive structure of the society, the latter is likely to be more affected than the former. The productive structure is likely to become more specialized and interdependent, and while the urbanite is likely to gain in income and variety of experience, he is also likely to bear a cost in terms of lost autonomy.

Samuel Huntington has analyzed societal development in terms that show how this shift in the locus of power from rural to urban is likely to cause instability, at least for a time, and perhaps the emergence of a new but stable pattern. In the example below he reasons largely in terms of geography and sector of activity, without explicit focus on power relationships, and his approach broadens and deepens the foregoing analysis.

According to Huntington, both agricultural and urban societies could be stable, but the transition from one to the other is fraught with difficulties and instability (see Table 4.2). Urbanization leads to additional political consciousness, which in turn leads to opportunities for political leaders to mobilize possible followers. In the process of mobilizing newly urbanized citizens, almost all societies have experienced considerable corruption, including vote-buying and kickbacks to political

Table 4.2 Political modernization: changes in urban–rural power and stability

Phase	City	Countryside	Comments
1. Traditional stability	Stable subordinate	Stable dominant	Rural elite rules; middle class absent; peasants dormant
2. Modernization and take-off	Unstable subordinate	Stable dominant	Urban middle class appears and begins struggle against rural elite
3. Urban breakthrough	Unstable dominant	Stable subordinate	Urban middle class displaces rural elite; peasants still dormant
4. Modern stability	Stable dominant	Stable subordinate	Countryside accepts modern values and city rule

Source: Adapted from Samuel P. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968), 76. Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (B)," case no. 702-097, Boston: Harvard Business School, 2002. Copyright © 2002 by the President and Fellows of Harvard College. This case was prepared by Jamie Matthews under the direction of Bruce R. Scott as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Reprinted by permission of Harvard Business School machines. Meanwhile, entrenched interests may slow the process of modernization, or stymie it entirely. Whereas our focus is on democratic capitalism, Huntington rightly emphasizes that "the most important political distinction among countries concerns not their form of government but their degree of government."[9] Initially governments have to mobilize or maintain more power than rural aristocrats in order to develop the institutions of an urban, industrial, and service-based economy.

The transition from an agricultural to industrial society represents development, but signals neither the beginning nor the end of the developmental process. The next step appears to be a transition to a largely service-oriented economy; and beyond that toward an economy where the financial sector plays a dominant role.[10] Transitions anywhere along this developmental spectrum challenge a society to make technical modifications in its institutions. To succeed, a society must acquire or create the capabilities to master more complex institutions; it must mobilize the political power to legislate them; and it must develop the administrative capabilities to implement them. Acquisition, creation, and mastery of institutional reforms requires not one but several processes of societal learning in a context where resistance to change is almost a given. Development in a contemporary context assumes the availability of an educated elite who can understand the more complex institutions and master the arts of implementation. In addition, these elites must have some sense of civic obligation if the new knowledge is to serve a purpose beyond the enrichment of a privileged elite. Thus, a seemingly simple change may require many steps, and telling someone to change is not the same as showing them how, let alone giving them the chance to master the new skills. It is relatively easy to explain the game of golf, and not too difficult to find experts who can show a good student how to "drive, chip and put." But that does not assure that the intended beneficiary will be able to hit the ball, let alone hit it straight or to stay away from the sand traps.

Huntington's scheme for the study of political modernization implies that a society can shift its centers of power from great agricultural estates to urban concentrations of power, whether in manufactures or commerce. For this developmental process to succeed, a rural aristocracy has to cede power to a rising urban aristocracy that is commercial and industrial or move to occupy an urban position themselves. Such a shift is almost certain to invite political struggle, as the potential losers delay or derail the process. Furthermore, the move away from agriculture can involve the displacement of many people, who must search for new employment, perhaps in a new locale. Historically, this displacement is fertile ground for political machines, some of which help the formerly rural poor find their way in the urban setting and some of which may try to mobilize political opposition to urbanization. These two circumstances create a context that is ripe for corruption and abuse. Industrial countries have long since undergone such transitions, and can be expected to have more advanced institutions, better educated people, and a more stable political context.

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[9] Samuel P. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968), 1.

[10] Martin Wolf, "Unfettered Finance is Fast Reshaping the Global Economy," *The Financial Times*, June 18, 2007.

Low-income countries may have a much greater backlog of obsolete institutions in need of modernization.

The institutional challenges to modernization can be far more deeply rooted than is indicated by these countries' relative income levels. For example, a Central European country preparing to join the European Union faces an agenda that may reach 80,000–100,000 pages of rules and regulations. One great advantage of admission is that the applicant country has little choice (and therefore little decision-making challenge) in how to reshape its institutions. Admission is basically a take-it-or-leave-it proposition—creating a powerful yet external force for modernization. The developed countries have modernized their institutions and are thus governed differently than their less developed neighbors in the global community. In addition to and because of their more developed institutions, these industrial countries are unlikely to have structures of power and wealth that are as unequal as those in less developed societies, and especially those in Africa or Latin America. So modernization is a lot more complicated and cumbersome in a developing country than in one with already developed institutions, and implementation of the Washington Consensus' principles of reform is correspondingly more difficult. On the other hand, there are some exceptional developing countries with egalitarian structures despite having many backward economic institutions, India being a famous exemplar.

Before figuring out how to achieve development in such countries, we must first analyze what development actually means. Development implies urbanization, industrialization, and increased emphasis on education, which are in turn dependent upon the introduction and mastery of new technologies to provide opportunities for profitable investments that create new jobs and increase productivity. The successful introduction of new technologies in turn requires that individuals, either on their own or as members of a firm, have both the freedom to adopt and improve new technologies, and an appropriate set of incentives to create and master the innovations needed to turn those new technologies into successful products and processes. While we think of each of these steps as a challenge for the private sector, the private sector can only perform as well as is permitted by the institutional context provided by the government of a society, as suggested by the three-level model of capitalism; these steps are thus a challenge for the public sector as well. And of course government can go beyond passively permitting development to happen; it can actively facilitate certain kinds of behavior, as, for example, by providing public goods such as roads and canals to facilitate travel or the provision of schools to encourage human development. In other words, government must be a successful entrepreneur in the modernization of the institutional context if the private sector and society itself are to have the opportunities for development that they deserve.

To meet their responsibilities to society, political leaders must place political capital at risk in order to secure the votes needed to bring about innovations in institutions, policies, and the physical infrastructure. They can make huge mistakes as they forge these entrepreneurial commitments by trying to impose wrong-headed policies, for instance creating patronage regimes that waste a country's resources, or even by overspending and bankrupting the country. Private entrepreneurs have done likewise, sometimes costing the jobs of tens of thousands of employees, destroying billions of dollars in shareholder value, perhaps even leading to a takeover of control by the sovereign. But historically speaking, political actors have been key; success required that those with political power relinquish some of it for the benefit of private actors who would put mostly private capital at risk and pay taxes for the privilege of trying and succeeding.

Europe as a Special Case

Urbanization in Europe, in the critical period 1400–1800, was quite different from elsewhere then or since. A crucial part of that difference was in the power structure in rural areas, and the self-sufficiency with which they were associated. European development over those four centuries entailed a societal transformation from feudalism toward a market-based oligarchy, as suggested in Fig. 4.2. These two processes, the development of decentralized economic markets to replace self-sufficiency as well as barter, and the development of oligarchy to replace monarchy, could theoretically proceed side by side, as if the economic and political systems were only indirectly connected. Urbanites could be allowed more economic power than political. Even so, this transformation of society entailed the risks of which Machiavelli warned. The bourgeoisie were free to innovate through entrepreneurial activity at their own risk, but they could expect the enmity and opposition of the aristocrats who would lose rural labor to the towns. The agricultural aristocracy could expect to have a decline in relative incomes even if, as might be expected, average incomes were to rise and reduce poverty. And that might not be the only drawback for a group in power.

The aristocrats were not the only vested interest facing a potential loss of power; the Catholic Church faced a similar loss. Urbanization implied better education and more possibility for spiritual autonomy in an economic context that was likely to be more interdependent. Whereas this implied gains for some people, it implied short-term costs for the aristocracy through a reduction of the rural supply of labor. In

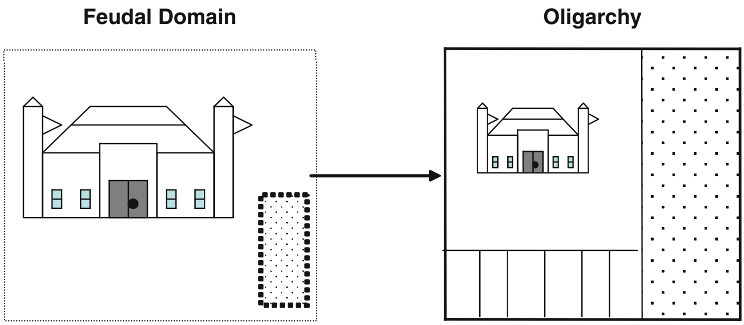

Fig. 4.2 From feudalism to oligarchy. Source: Bruce R. Scott

societies where the Catholic Church exerted a strong political influence, the rural aristocrats were sometimes able to form alliances with the clergy, enlisting them to arrest, imprison, or even execute the would-be entrepreneurs, as was the case both in Portugal and Spain, thanks to the remarkable power of the Inquisition in the 16th century. There were similar issues when it came to the advancement of science. The Catholic Church could shut down scientific inquiry whenever it deemed the exposition of findings as both heretical and likely to reach a wide public, as in Galileo's discovery of moons in orbit around Jupiter. Science was permissible, but advocating a heliocentric view of the universe was a direct challenge to the authority of the Church and was punishable by death.

Another basic societal challenge to vested groups lay in the idea that capital should be allowed to earn interest, a concept that was not fully accepted through most of the Middle Ages in Europe, and still officially is not accepted in some Muslim countries. Accepting the notion of a return on capital would provide motivation for development of new instruments for the extension of credit, and new institutions for insurance. Moreover, it might allow the accumulation of wealth (and power) by non-aristocrats and non-clergy.

And European colonies were different from their mother countries. Figure 4.2 allows us to distinguish the development of Europe from two other lines of development that were embraced by European "entrepreneurs" and adventurers, beginning in the early 1500s, with radically different trajectories from those transpiring in Europe proper. First there was the exploration and conquest of the Western Hemisphere, as well as incursions into South Africa and South Asia, e.g., India, Indonesia, and Malaysia. In these adventures, Europeans introduced systems of governance abroad that implied social structures that were at odds with the direction of change in Europe. Namely, while capitalism spread gradually in European cities and towns from 1400 to 1800, accompanied by a widespread increase in personal freedoms and a move from feudalism toward oligarchy, these same European societies were founding colonies based upon systems far harsher than feudalism. While the Europeans were moving their domestic social systems from left to right in Fig. 4.2, they were simultaneously establishing new colonial regimes that might be labeled as even more repressive societies, with widespread use of forced labor or even slavery, and thus moving in the opposite direction. In many of these cases, the imposition of various forms of forced labor (and thus fixed, immobile factor markets) in the colonies delayed the emergence of capitalism by centuries. The history of this development, as illustrated by the conquest, settlement, and governance of Latin America between 1500 and 1750 will be examined in Chap. 6.

But this was not the only developmental path possible in the colonial realm. Beginning in the 1600s, the Europeans began to settle parts of North America in quite a different way than they had settled Latin America. Particularly in Massachusetts and with a few decades of delay in Virginia, colonists adopted the institutions of capitalism and local democracy. And virtually from their inception, the largely British settlements north of the Chesapeake Bay were based upon widespread access to the ownership of land, most of it in parcels of small to modest size for cultivation as family farms. Recognized by political leaders as remarkable, this pattern of land ownership proved conducive to the establishment of the institutions of democracy virtually from its inception. In addition, the British colonies in North America were governed at the local level by direct democracy through town meetings, and colonists elected colonial legislatures responsible for providing the income to pay for the colonial governors nominated by the English crown. While Lower Canada (Quebec) started out under a French-inspired feudal system, this changed after British conquest of Canada at the beginning of the 18th century.

In these circumstances, the northern colonies never experienced entrenched development of feudalism and thus had little by way of feudal institutions to overthrow. Furthermore, the land that they occupied had no gold or other recognized mineral wealth, nor the climate and soils to produce valuable export crops such as sugar or cotton. Such modest circumstances spurred these colonies to offer land to prospective colonists in order to attract them to risk the Atlantic voyage. As a result, these colonies maintained exceptionally egalitarian income structures. They were characterized by near-universal family ownership of land, and a decentralized and market-based economic decision-making system from the start. There was therefore no pressing need to move any more "rightward" on Fig. 4.2. This exceptional history—only Australia and New Zealand had even roughly comparable circumstances, and their settlement began more than a century later—will be further examined in Chap. 7.

These simple models can help us visualize two quite different scenarios for development in the Western Hemisphere, beginning about 1500. Of further interest is a third scenario eventually following the latter, egalitarian one in the early United States, as I will briefly explain here but describe in more detail in Chap. 13. The egalitarian model that was established in New England and extended to the mid-west in the Northwest Ordinance, set up the outlines of a power structure for the northern region of the United States that was admirably suited to capitalism and democracy. This legislation passed by the Continental Congress just prior to the adoption of the Constitution, was land planning on a very grand scale, inspired by Thomas Jefferson and John Adams, and deliberately conceived as a way to promote democracy by providing near-universal opportunities to acquire a stake in the economy and society. The Northwest Ordinance called for the division of some 250 million acres west of Pennsylvania and north of the Ohio River into 640 acre squares; these were then subdivided into quarter sections which were admirably suited for a family farm and thus the promotion of a society of yeoman farmers. But the notion of independent yeomen farmers depended upon more than just the relatively egalitarian allocation of land. It also depended upon the fact that this was some of the best farmland in the world and the fact that most of the farmland had sufficient rainfall so no irrigation was needed, thus making the farms and the farmers virtually autonomous from one another. A farmer could come to town to shop for supplies or even to trade, but was largely economically self-sufficient and thus autonomous in a political sense as well. Since there were no great estates in this area and no factories of any consequence, there were few if any towering oligarchs and little need for productive organizations more complex than the family farms.

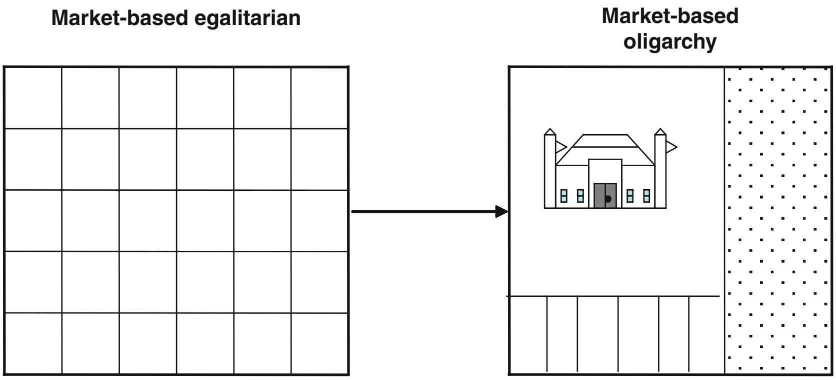

Fig. 4.3 From egalitarianism to oligarchy. Source: Bruce R. Scott

This scenario soon changed, however, with the advent of new transport technologies such as canals and then railroads in the 1840s. These great infrastructure projects reduced transport costs and extended the effective trading radius for producers and consumers. At the same time, they tended to reduce the autonomy of the farmer. More of the crop went to market, and incomes were more dependent on events far away. From the 1820s onward there would be larger firms, and powerful oligarchs began to appear. Then, as settlement went further west, water rights became a vital aspect of social organization. Who had those water rights? This was hardly the stuff of bilateral deals among consenting adults. The United States began to move toward the oligarchic model during the 19th century, as suggested by Fig. 4.3. And the oligarchs were basically in the private sector, and not in government.

This same scenario has been extended in the 20th century in the United States through the legacy of the Northwest Ordinance. Whereas the Ordinance gave the United States an unusually equal power structure when it was promulgated, and for at least a century thereafter, beginning in the second half of the 19th century that same distribution of the land into townships with local powers of governance and taxation became a vehicle for facilitating a concentration of power in the hands of large firms, as described in the Prologue. The small units that were established as the legitimate holders and governors of zoning rights shrank in significance as firms got bigger, for instance in mining and manufacturing and then, in the 20th century, in retailing. Yet, the United States has continued to govern its land usage largely through the institutional structure established in 1787. The result has been to create a situation where the representatives of the public interest were dwarfed by private parties. GDP growth in these circumstances was propelled in part by the laxity of the zoning boards to add appropriate costs to reflect considerations for the overwhelming of local communities by corporate interests. While development was essential for a growing population, land was cheaper and suburban sprawl became the model, in considerable measure because the United States failed to modernize its political institutions to keep up with the growth in power of its industrial and then its retail giants. England and New England have been governed by very different land use regimes, as we discussed at the outset, and these differences affect the patterns of everyday life and indeed the quality of life in ways that are not well reflected in the national income accounts.

For a fourth illustrative scenario, consider the frontier experiences of the Dutch. The Dutch were able to reclaim land from the North Sea and turn it into farmland. They had a frontier right in the middle of their country, but it was below sea level. As they recovered the land, they could also divide it as if on a blank sheet of paper, but the outcome was bound to be very different. To reclaim the land the Dutch had to build dykes and drain the land. They needed social organization to accomplish this. Was that organization to be private or public? Whichever, it would have great power over the lives of the people who lived there.

Now take this same mental model of production to a fifth historical scenario in Indonesia, where there were mountains close to the sea, but with sloping land in between. The rivers coming down from the mountains could be harnessed to irrigate the gentle hillsides if the latter were terraced, and if there were some form of organization to sponsor a canal system, to allocate the water, and then to maintain the system and police the allocations. Should this be done by the private sector and, if so, should it be on the basis of voluntary negotiations? The notion that voluntary negotiations among consenting adults are what characterize capitalism is a particularly British and American idea that owes its seeming universality in part to the geographic conditions in these two countries, starting with good soil and adequate rainfall. The Arabs along the Nile and the Euphrates had and still have a different set of circumstances to deal with, and also the Chinese along their great rivers, the Yellow River and the Yangtze. The organization of production was not necessarily based upon market trading in much of the world before the Industrial Revolution, and still less afterward.

The characteristics of market trading even changed over time in the United States, where it started from an atomistic, laissez-faire economy from 1630 until about 1830, and was then transformed into an oligarchic laissez-faire regime for the next century. It changed gears once again in the 1930s to create a more social democratic regime with a much stronger regulatory role for government, only to turn back toward the laissez-faire model again in the 1980s. While the United States was obviously dealing with differing circumstances over 3 centuries, these changes in it capitalist regime were not dictated by economic circumstances nearly so much as by human agency as mediated through competition for control of the political system. Thus, in the north the United States experienced some 200 years of a market-based economy in an egalitarian power structure because of some remarkable geographic circumstances, among others. But beginning about 1830 the United States embarked on a transformation toward a market-based oligarchy, a transformation mentioned above and described in detail in Chap. 13. This transformation was powered by laissez-faire capitalism, which empowered entrepreneurs to develop and exploit new technologies initially driven by water, as in textile mills, and then by steam and electricity. In these radically new circumstances, the symbols of power were the smokestack and the office building, and not the chateau, as suggested in Fig. 4.4.

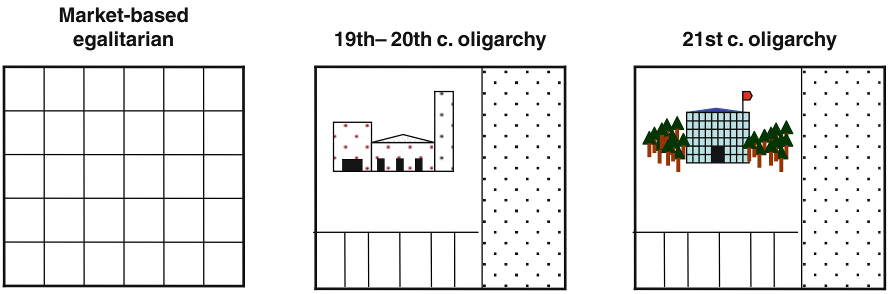

Fig. 4.4 From an egalitarian system to oligarchy in an industrial age. Source: Bruce R. Scott

Then, between 1941 and 1945, US income inequalities would be radically reduced, not by capitalism but by the exigencies of World War II. Beginning in 1980, the US income distribution pattern would again move toward oligarchy, with incomes more unequal than any other industrial country. This time the extraordinary incomes were not in the railroads or other industrial sectors, but emblematically in finance, giving rise to Wall Street as the new symbol for oligarchy in the new millennium. Since 1980 there has been a steady rise in the share of income accruing to capital relative to labor, a trend that seems likely to be a harbinger of something that could be worldwide. I will return to this topic in depth in Chap. 14.

Here it should suffice to note that the United States has experienced a radically different developmental path than the one traversed anywhere in Europe, particularly with regards to the United States' tolerance for oligarchy, as illustrated by the differing patterns of land usage noted just above. This distinct path is partially explained by the history of Europeans' struggle for liberation from oligarchy. Indeed, the Europeans were working toward a more egalitarian structure while the United States was slipping into oligarchy in the second half of the 19th century. As we enter the new millennium it would appear that the fast path to oligarchy is no longer to be found in producing anything tangible at all, besides greater leverage and greater financial returns. But the point to note in this final, contemporary scenario, is that it is *capitalism* that has been driving the United States toward oligarchy for almost 200 years. The corollary to this is that the countervailing power that has been used (or not used) to reign in the coercive powers of the private sector has been none other than government.

Structure and Strategy in the Provision of Public Goods

How did the increasingly capitalist, and increasingly oligarchic, structure of US property and power relationships influence US opportunities for development? Consider the issue of schools. Schools are at least as vital to the development of human capital as banks are to the development of financial capital. They not only help transfer knowledge and skills and attitudes from one generation to the next, they help create a culture that values lifelong learning. Given the continuous competitive pressures for the modernization of capitalism, educational systems in turn face pressure to modernize on top of those involved in delivering a high quality if traditional product. Educational failures are a sure path to underdevelopment. From its inception until about 1970 the United States was a world leader if not the world leader in public education, and the structure provided by the Northwest Ordinance was a contributor to that leadership.

Let us return to our two illustrative communities, one egalitarian and the other oligarchic. Consider what might be required to finance a public school system in order to develop the human capital of the residents first in the egalitarian community and second in the oligarchic one. In 1800, even most egalitarian communities had, at best, rudimentary primary schools. But incomes were also much lower. So, how was a modest budget for schools to be financed? The United States provides a prime example. It was a common practice in the United States to begin school systems with individual tuition payments on the basis of usage. In time, this would switch over to tax-based schooling, a decision that flowed in part from the recognition that families with young children had many demands on their limited incomes, demands which predisposed private decisions on the education of children to fall well short of what was best for society, i.e., a potentially damaging market imperfection. Poorly educated children could well under-perform throughout their lives. Tax-based schooling removed this dilemma by spreading the burden across all age groups. On the one hand, this solution meant that some families, e.g., those without children, would pay more than their fair share, and thus be imposed upon by a domineering state in the framework of Milton Friedman. But on the other hand, society as a whole would gain in terms of the development of its human capital.

Any relatively egalitarian society would be similarly well placed to adopt a system of compulsory education and spread the costs across the whole community through taxation. In so doing, all residents would have to contribute to the costs of schooling, rather than concentrating the financial burden on families with school-age children. In the circumstances of a community with an egalitarian distribution of land, a direct tax on real-estate is an obvious possibility. Where property ownership is near-universal and relatively equal, all land owners could be expected to be assessed some minimal tax, and those with larger houses or better land would pay more. A person's wealth would be visible, and thus the tax system could be transparent. Tax assessment at the local level would also facilitate a very direct and rapid accountability of the schools to the communities that they served, perhaps through regular publication of the results in an annual report for the township. Even if parents were amateurs when it came to the essentials of education, they could become involved in the practice of democracy, based on local accountability and control, and perhaps they could achieve equilibrium between the education that they wanted for their children and what they felt they could afford.

This discussion of public education can be brought to bear on public goods in an egalitarian community more generally. An egalitarian society creates a situation favorable to the development of local resources through political as well as economic markets, i.e., a situation where capitalism and democracy are truly symbiotic.

The development of Latin America and the United States offer historic confirmation of this rule, as Chaps. 6 and 7 will explain. Exhibit 7.9 shows how strikingly different the patterns of land ownership were in the United States in the 19th century from the patterns in Latin America and Mexico. At the turn of the 19th century, only 19% of Argentineans and 2.4% of rural Mexicans owned land—compared with almost 75% of Americans and more than 80% of the Canadians. The United States, as a more egalitarian community, enjoyed a very remarkable development of taxing powers at the local level, thus supporting a strategy of local initiative. In 1855, for example, only 25.5% of tax revenues went toward the national government in the United States, whereas a full 57.1% found its way into municipal or local coffers, and 17.4% went to state government. In Brazil, by comparison, 79.5% of taxes went to national government, and only 3.3% was set aside for local distribution in 1856, while 17.1% was earmarked for provincial use.[11] The Latin American countries had much more centralized patterns of tax collection and thus of governmental initiative. They also collected less in the way of revenues, and distributed fewer public goods, as we will see in Chap. 6.

Local government's capacity to raise more revenues through taxes, mostly real-estate taxes, than state and federal levels combined[12] in the United States promoted investment in the public goods that would help Americans become productive (i.e., roads, sewers, schooling, and public health). The US enrollment rates were higher than those of any other country except Prussia by 1830, as shown in Exhibit 7.11, and the US literacy rates dwarfed those in Latin America during the 19th century, as shown in Exhibit 7.15. Not surprisingly, the United States rapidly became a world leader in the development of public education. Canada was also an early leader, though its taxes were assessed by province rather than at the local level, as was indeed the case for some states within the United States. The local governance over public goods allowed such egalitarian societies to wield an advantage when it came to the modernization and/or upgrading of their schools. If citizens wanted better schools, they voted for an increase in their taxes and were well placed to achieve public support to fund the desired improvements (based on transparency, broadly equal incidence, and local control of the proceeds). Compulsory public schools permitted a continuing upgrading of community resources. Moreover, most children came from similar socioeconomic backgrounds and could be expected to have reasonably equivalent starting positions in terms of values and norms established at home. Beyond education, similar success could be achieved (for similar reasons) for the financing of infrastructure and law enforcement.

The early success of US public goods thus came from the colonies' egalitarian distribution of land and thus, in turn, can be traced to that same Northwest Ordinance. The pattern of land holdings developed in New England and extended

[11] Kenneth L. Sokoloff and Eric M. Zolt, "Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions," *Tax Law Review* 59, no. 2 (2006).

[12] The exception to this rule of lower-federal taxes until the 1930s were those funds raised for wartime emergencies such as the Civil War and World War I (see Sokoloff and Zolt, "Inequality and Taxation").

westward through the Northwest Ordinance created a structure that would facilitate the development of the human resources of the United States. It was legislation that would facilitate though not dictate the development of democracy alongside capitalism. With a strategy focused on developing human capital through public schools rather than private initiative, the United States would pass most of the European countries soon after independence in terms of literacy, and would pass all of them for which we have data by 1850, in terms of the fraction of the population that had a primary school education.[13] Though the implementation of the Northwest Ordinance did not produce quite the egalitarian model implied by the surveyors' squares, it contributed to a uniquely egalitarian distribution of property for its time, as well as to the growth of a nation with a population focused upon the idea of opportunities for most if perhaps not all people, i.e., the notion of freedom for all and not just for a wealthy elite. This strategy could hardly have been more different from the free market strategy espoused by Milton Friedman in his *Capitalism and Freedom*. Government had laid out the basic framework for creation of an egalitarian structure of property holdings, and this egalitarian structure facilitated the early development of public education. The US strategy was based on the use of public policy to empower its citizens, rather than leaving it to each family to decide whether its children should be educated, which, as I will now discuss, was the oligarchic model and resulted in the education of a much smaller elite.

An oligarchic society could expect to face more opposition in any attempt to educate its population, as the example of Latin America illustrates. Attempts within oligarchic societies to finance public schools at the local level, via taxation, meet a formidable opponent in the large landowner who would face a very large total assessment relative to that of his neighbors. The landowner could be expected to oppose such a tax and to have a strong temptation to refuse to pay. The logic is simple. There are many poor families in this township. They have little property and will pay little tax. On the other hand, each poor family can have as many children as the rich family, and, in aggregate, children from poor families are likely to dominate the local school. If the rich families paid their property taxes, most of their payments would go to subsidize the education of their poor neighbors.

Oligarchic societies encounter further obstacles beyond taxation when setting up schools. Since many of the school children come from less advantaged backgrounds, they will not be on a socioeconomic par with those of the rich families, and therefore not likely to be on a par in terms of their ability to achieve at school. This means that the rich oligarchs would be paying a disproportionate fraction of the costs of a school system in which their children will likely not be as well educated as they would in a private school directly funded by the elite and essentially reserved for their own children. The market solution for the rich is, accordingly, to

[13] One historian estimates that, in 1830, the primary school enrollment rate (per 10,000 population) was 1,500 in the USA to 900 in the United Kingdom, 700 in France, and 1,700 in Prussia/Germany. In 1850, he estimates that the USA's rate was 1,800, as compared to 1,045 in the United Kingdom, 930 in France, and 1,600 in Prussia/Germany. See Richard A. Easterlin, "Why Isn't the Whole World Developed?," *The Journal of Economic History* 41 (March 1981): Table 1, 18–19.

send their children to private schools and to oppose anything but minimal schooling for their neighbors' children. Such a market-oriented solution is both undemocratic and irrational for the oligarchic society as a whole, in that it denies educational opportunities to a majority of the children. When it comes to public goods and services, unequal purchasing power, if not offset by governmental intervention, virtually assures a sub-optimal, undemocratic outcome for the already undemocratic society. It provides a path to aristocracy. Here government has to be a guarantor of freedom and opportunity for those of modest income, if its society is to flourish. Capitalism without effective government is a recipe for increased oligarchy and eventually for instability.

If there are to be public schools in oligarchic societies, they are likely to depend upon the taxing power of a provincial or even federal government. These higher levels of government have a much broader base from which to collect indirect taxes such as those on sales, trade, or luxuries. With a system of indirect taxes, the rich are not singled out for extra contributions above and beyond what they owe for the transactions that they generate or the luxuries that they consume. In reality, indirect taxes approximate a system of "flat" taxes, where all pay taxes at the same rates and some people pay more taxes because they consume more. Such a tax system is regressive, hitting the poor much harder than direct taxes on income or property. In order to minimize their regressive impact, the indirect taxes are likely to be set at a low rate, and the revenues generated per person are then likely to be quite limited. This means that for societies with an oligarchic property distribution, governments will have very limited revenues unless there are rich mines, export crops to tax, or taxes on imports. It also suggests that local governments will be heavily dependent upon financial grants from higher levels of government and that their citizens will have much less of an opportunity to participate in and take responsibility for local government.[14] Thus, societies that permit private oligarchies to amass great power are at risk of under-providing public goods and under-developing human capital. Those who, like Friedman, extol freedom theoretically for all but in practice for the few are neglecting the societal costs that go with good schools for a few and mediocre schools for the rest of society.

The oligarchic model is also useful for exploring patron–client sociopolitical systems. We expect a country with an oligarchic power structure to have under-funded public goods and services, with its education system standing as a likely example. With little public education or law enforcement, the patrons or chateau owners on the big plots of land are in a strong position to exercise considerable political power over their much poorer neighbors. They could be a source of patronage (bestowed through employment, favors, and gifts) and punishment (intimidating neighbors who do not do their bidding), as well as more substantial government influence. Thus, although the differences between egalitarian and oligarchic societies initially seem to be just based upon wealth, they are also based upon law, i.e., they are likely

[14] Sokoloff and Zolt, "Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions."

to be embedded in legal systems that, at a minimum, do not afford equal protection under the law. The wealthy may well use the police as an instrument to abuse the poor, thus greatly exacerbating the inequalities of power. It would be all too natural for rural oligarchs to use the power of the police or of local militias to retard the development of manufactures and other areas of diversification to minimize the opportunities available to their local labor supply, as well as its base in terms of knowledge and skills.

Thus far, we have modeled societal power relationships as either economically or politically determined, with modifications in light of special geographic circumstances and changing technologies. And, to simplify our analysis, we have assumed that each of our societies is an essentially homogenous entity, populated by ethnically homogenous groups; the variations are among the rich, the poor, and a middle class. But societies have much more texture than is implied by the simple drawings of land holdings. Consider the possibility that the families in the chateau and the other substantial landowners are of different skin color, ethnic background, or religious faith than those in the very small plots of land. This could easily affect the processes of governance. Familiar examples include enclaves of ethnic Chinese living among much less wealthy Malays in Indonesia, Malaysia, or the Philippines,[15] as well as Indian merchants in East African countries who controlled very disproportionate wealth. Both examples resulted in conflict; in the Malaysian countries the rich foreigners were singled out for persecution or execution, while the Indians were largely driven out of East Africa. The elites can live in their exclusive compounds for a time, accepting little or no responsibility for their neighbors, but circumstances can change, inducing hostility and perhaps violence as well.

Great inequalities in wealth and power can become the basis for low (i.e., insufficient) taxes and the under-provision of public goods, creating a situation comparable to an incomplete state, where the rich can take care of themselves while ignoring the needs of the middle and lower classes. Great inequalities can thus create freedom for the few and a lack of opportunity for the many. In contrast, when most people own property in relatively similar amounts, a strong incentive exists to have more adequate law enforcement, yielding many collateral effects. Citizens will likely share an interest in developing a set of instruments to designate land ownership, i.e., deeds and such institutions as a registry for such deeds, a process for recording them, and a process for searching to verify such titles. One could also expect the emergence of instruments for borrowing against land, such as a mortgage, and the development of institutions that permit foreclosure on a mortgage for non-payment.

But again, it is not just conditions that determine outcomes. The United States was well placed to reform its political subdivisions for the management of land, but basically has not done so, as noted just above. Business interests, such as real-estate developers, have been powerful enough to keep the focus on short-term development to spur local tax collections, with little thought for the longer term. Theoretically,

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[15] See Amy Chua, *World on Fire: How Exporting Free Market Democracy Breeds Ethnic Hatred and Global Instability* (New York: Doubleday, 2003).

the United States is again extremely well placed to do the opposite because many of its states have enacted laws or constitutional amendments that permit direct democracy via the initiative petition, bypassing the legislature in favor of direct legislative action by the voters. The results have often been quite the opposite, with small groups mobilizing public opinion to support referenda that reduce taxes and public expenditure on the grounds that this is the route to curtailment of waste, fraud, and abuse, as though the latter were budget items. California's Proposition 13 has to be one of the most unfortunate and shortsighted pieces of such legislation, single handedly helping to do great damage to one of the best public school systems in the United States. It achieved by a simple majority vote a requirement that new taxes require a super majority, while at the same time prohibiting revaluation of real-estate for tax purposes until a piece of land is sold, two rules that have combined to help reduce California's public education to about the levels prevailing in Arkansas and Louisiana.[16] While direct democracy was promising when initiated in the 19th century as a way to countervail the very large firms, its revival in the 20th century seems largely characterized by shortsighted, populist legislation, as chronicled by David Broder and others.[17] An egalitarian structure of income is conducive to the creation of capitalism, and democracy, but is no guarantee of either. The story is much the same everywhere. It takes human agency to design and achieve the outcomes that serve the public interest. Markets alone are not enough to do the job. Markets can coordinate within a given structure, but they cannot change that structure as societal needs change. Structural change requires governance by the visible hand of a political authority.

Conclusions

This chapter was designed to articulate several models of economic and political power and to explore their implications for the development of capitalism and democracy. With these models we can readily think of alternative developmental scenarios. The escape from feudalism was and is most likely to be via oligarchy, with political conflict and some risk of a miscarriage into dictatorship of the left or right. Certainly, a select few societies were lucky enough to settle vast areas that were lightly populated and aggressive enough to ignore the rights of the existing indigenous populations, had a blank sheet of paper on which to build egalitarian societies. However, to recommend that others follow this fortunate model is like recommending to a struggling amateur golfer that he or she play like Tiger Woods or Arnold Palmer. It is a nice idea, but more than just a bit naïve.

The models put forth in this chapter also help us recognize some of the dynamics facing most countries today. Oligarchy is the most common condition extant, and

[16]For an excellent account of these failures in self-rule, see David S. Broder, *Democracy Derailed: Initiative Campaigns and the Power of Money* (New York: Harcourt, Inc., 2000).
[17]Ibid.

especially for developing countries. Any development strategy that is likely to lead to increased inequality in these societies carries political risks. To ignore such risks is not a show of libertarian idealism but of ignorance of the real problems facing developing countries.

Even relatively egalitarian societies face challenges, as capitalism will tend to drive an egalitarian society toward oligarchy. Capitalism, paradoxically, may also drive feudalism toward oligarchy by promoting the movement of capital and labor toward higher value usage, once feudalism has begun to open toward greater freedom and initiative. Thus, while capitalism tends to subvert the extreme concentration of power of feudalism, by promoting new centers of economic power, capitalism can also be expected to promote inequality and oligarchy if allowed to flourish unimpeded in an egalitarian context.

At first sight it would seem axiomatic that an egalitarian society is congruent both with capitalism and democracy, while a feudal regime is consistent with neither. However, it is important to note that capitalism cannot take form without political decisions that permit a decentralization of economic power, decisions that are in turn greatly influenced by geographical context. A society that appears egalitarian can be expected to have quite a different power structure if people's incomes depend upon sharing water resources for irrigation, or if they depend upon a system of dykes to protect the population from the North Sea. The US experience with decentralization and autonomy based on rain-fed farms was not unique but fortuitous; both geographical endowments and human agency through political decisions were required.

There are three important practical conclusions to draw from this chapter and its predecessors. First, the free markets of deregulated capitalism are *not* a stable, long-term strategy for the advancement of freedom or the maintenance of democracy. Rather, the free market strategy serves to empower the winners in capitalistic competition to create an economic oligarchy and, further, to abuse their power by repressing the provision of public goods and broadly based opportunities for the population as a whole. In addition the oligarchs may be tempted to corrupt government for their own advantage, further entrenching their relative positions. We will examine a remarkable example of just this phenomenon in Chap. 13, when we consider how the egalitarian structure of the United States was undermined by free market capitalism during the 19th century to a degree that jeopardized its democratic structure and led to the emergence of direct democracy as a partial remedy.

Second, economic markets will not normally cure economic or political inequalities except perhaps in an extremely unequal context, i.e., a context that is approaching feudalism or absolutism, and then only if there is remarkable law enforcement to restrain temptations to abuse power. Reducing inequalities and maintaining a relatively egalitarian power structure in much less distorted circumstances, such as any of the industrial democracies of recent decades, requires timely and effective government intervention based upon mobilization of public opinion through political markets. To clarify, this assertion is very different from a stance that encourages government ownership of firms. There are numerous ways that government can intervene, and direct ownership of firms need not be a first or even second choice.

However, the limited government advocated by Friedman and others is a recipe for allowing private oligarchs to corrupt political and economic systems, empowering elites to take advantage of the population at large. It is a recipe for a level of oligarchy incompatible with Lincoln's challenge of government *for* the people.

Third and finally, an egalitarian distribution of incomes will facilitate growth through the widespread provision of the public goods needed for a population to develop its talents and integrate new technologies and production processes. Egalitarianism enables the collection of tax revenues adequate to finance these levels of public goods, consequently creating a potentially virtuous circle. However, this potentially virtuous circle depends upon government intervention to offset the naturally hierarchical productive side of capitalism, i.e., through firms, for example, or through maintenance of adequate funding for public schools. As US communities become more stratified by income levels, the purchase of a home is increasingly buying one's way into a school system supported by other similar homes. What was a public school system in the 1950s and 1960s is increasingly a stratified semi-private school system where the entry costs constitute a form of discrimination based upon wealth and income. Thus, maintenance of an egalitarian society depends upon strong and effective government and not the minimalist version that it is claimed as adequate to lift the poor out of poverty and on to the good life.

Part II
The Origins and Evolution of Capitalism, 1400–1830

Prologue
The Mystery of Governance

In his influential book *The Mystery of Capital* Hernando de Soto tackles the failure of capitalism to flourish in developing countries, asking: "Why does capitalism thrive only in the West, as if enclosed in a bell jar?"[1] He begins by explaining that all developing countries have markets: "Markets are an ancient and universal tradition: Christ drove the merchants out of the temple two thousand years ago, and Mexicans were taking their products to market long before Columbus reached America." Having established the omnipresence of markets, and taken account of the amount of assets possessed by developing countries, de Soto theorizes that it is their inability to harness capital, "the force that raises the productivity of labor and creates the wealth of nations," that explains poorer countries' economic failure.[2]

In this opening argument de Soto conflates product markets with capitalism. Product markets surely existed and flourished in many ancient contexts, including Palestine in the pre-Christian era and in the Aztec capital in pre-Columbian Mexico. Absent from either of these two examples were factor markets for land or labor, much less anything but rudimentary markets for financial capital. Mexico had communal ownership of land, for instance, along with various forms of forced contractual arrangements whereby the inhabitants of an area were tied to the land and owed a certain measure of their output to the owner, an arrangement much like European feudalism at the time. Land and/or labor could not be purchased or sold in markets. The claim that markets are an ancient and universal institution is at least partly fallacious, as it overlooks the distinctive nature—and early absence—of factor markets. Economic failures in developing countries are based less on a shortage of capital than on ineffective systems of capitalist governance.

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[1] Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), 5.
[2] Ibid., 4–5.

As has been stated throughout this book, the sine qua non of capitalism is the presence of factor markets. Indeed, the Spanish conquest of Mexico was greatly facilitated by taking over an established set of feudal relationships for land and labor. As the Spanish extended their conquest throughout much of Central and South America, they took over and then maintained feudal relationships. Most of these relationships would not be overturned until the second half of the 19th century, or for roughly another 300 years, as we will see in Chap. 6.

De Soto's second mistake is his claim that "the major stumbling block that keeps the rest of the world from benefitting from capitalism is its inability to produce capital."[3] To my mind this is conflating capital, a factor endowment, which in this time period is mostly land, with a set of institutions such as property rights and the political authority to govern those property rights, i.e., with capitalism itself. In the language of this book, de Soto's view of capitalism unfolds on a single level, based upon product markets, and ignores the multi-level system of product and factor markets, institutions, and political governance. Developing countries are missing workable systems of governance, with feudalism abolished in both the land and labor markets, and with a form of government that legally limits the powers of the sovereign.

Capital is an important ingredient of capitalism, but it is by no means equivalent to the three-level system itself. In Chap. 5, we will see that capital, while it contributed to European success, was not the key to rising incomes. For instance, as some European states shifted their treasury functions from the royal household to an official central bank, their interest costs to borrow money dropped by as much as two thirds. Savers had much higher confidence that central banks, as opposed to absolute monarchs, would honor their debts. The missing force in many developing countries is that of an effective set of institutions that together constitute a competent and credible system of governance for their economic systems. Chapter 5 will illustrate how the Europeans created such institutions and why, and Chap. 6 will analyze where and why the South Americans lagged behind for almost 300 years. Chapter 7 will then show how the North American colonies, equipped with institutions that did more to develop human as well as financial capital, pulled ahead of those in South America. Governance does not flow across boundaries the way trade in product markets might. Factor markets and political markets are territorially distinct, even if they are contiguous, as we will see in Chaps. 8 and 9.

[3] Ibid., 5.

Chapter 5
Creating Capitalism in Europe, 1400–1820

Whereas the preceding chapters have focused on the theory of capitalism, the present chapter and those that immediately follow focus on the early history of capitalism. Why should a book devoted to putting forth a coherent, accurate conception of capitalism digress into a narrative of its origins? Such a switch is not a digression in the least. Confusion over the concept of capitalism has contributed to confusion over its origins, both in terms of timing and causality. Different conceptions of what capitalism is inevitably lead to different conceptions of when it first came to be, as well as how it spread from one society to another. Hence, any discussion of a definition of capitalism necessarily calls for a corresponding discussion of its history.

Many scholars have found capitalism a truly daunting concept to define and have therefore avoided defining it at all.[1] This evasion limits the clarity of their arguments about its origins and seems to me to be unnecessary. As an introduction to this chapter, I examine two instances in which well-established authors, facing such definitional difficulties, seemed to disagree on how they framed the events that unfolded between 1400 and 1800. I hope that I can clarify their disagreement by interpreting the events that gave rise to capitalism as distinct from the less formal trade regimes that preceded it. The clarification I seek here will be useful throughout the historical chapters that constitute the remainder of this book.

The challenges of defining the concept of capitalism stem from the sheer complexity of the system to which it refers; the failure to articulate a clear definition, in turn, influences how scholars describe its origins and how they analyze its day-to-day workings. Those authors who attempt to clearly identify capitalism tend to consider it in terms of its component parts without recognizing its totality. For example, those who claim that "capitalism" refers to industrialization define it in terms of how goods and services are produced and distributed; these scholars accordingly, tend to see the period before the Industrial Revolution as part of a different system, rather than a stage in an evolution of a system of governance that can be adapted to changing circumstances. Other economists, such as Milton Friedman, who claim

[1] For two recent examples, see Hall and Soskice, *Varieties of Capitalism*; Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*.

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_5,

capitalism refers to free markets, tend to focus on market-based transactions and the coordinating role of the pricing mechanism; they tend to trace capitalism as far back as they can find evidence of trade. But their definition of capitalism misses the notion of capitalism as a holistic system of governance or political economy, encompassing far more than markets and thus requiring far more than trade to exist.

I believe that capitalism has been particularly troublesome for such economists to define because of their tendency to focus on markets and thus on only one of capitalism's three coordinating mechanisms—the pricing mechanism—which appears to operate without the need for deliberate human agency to achieve an optimal result. Political scientists may lack depth in their understanding of capitalism because they view the internal economic relationships as outside the bounds of their field of study. Nevertheless, because of their background in considering systems of governance and human agency, they are more likely to view capitalism as a complete system, and thus to have a very valuable perspective to contribute. Historians should have been able to bridge these gaps through tracing how capitalist systems developed through time, but this depends upon holistic analysis of a high order in order to distinguish a system for economic governance (capitalism) from a system for political governance, such as limited monarchy or democracy. My goal in this chapter, and indeed throughout this book, is to straddle these three disciplines. In studying the origins of capitalism from the viewpoint of political economy and in recognizing three coordinating mechanisms, I maintain proximity to political science's focus on form (i.e., totality instead of parts), while hopefully achieving the requisite depth in the economics as well. In this chapter, I present a compelling historical case for the concept of capitalism that I proposed in Chap. 2, i.e., that capitalism is an emergent system of governance, a human construct, and not a natural system. This chapter ascribes the origins of capitalism to Europe, as do all other accounts with which I am familiar; at the same time it attributes those origins to the factor markets far more than to trade, and it attributes the spread of capitalism to political decisions far more than to the economics of markets.

My recognition of the need for an explicit definition of capitalism arose from reading Fernand Braudel's history of capitalism and recognizing that a working definition had eluded him for the 20 years he spent on his magnum opus. In the second of his three volumes on the history of *Civilization and Capitalism*, he confides that he finds the term "Ambiguous, hardly scientific, and usually indiscriminately applied, it is—above all—a word that cannot be used for the ages before the industrial period."[2] Yet, in the same volume he still ventures to provide a definition, and does so insightfully, if indirectly. In his third volume, he goes on to attach a historical imperative to his definition of the term, writing that "I have argued that capitalism has been potentially visible since the dawn of history, and that it has perpetuated itself down through the ages."[3]

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[2]Braudel, *Civilization and Capitalism, 15th–18th Century*, 2:231.

[3]Fernand Braudel, *Civilization and Capitalism, 15th–18th Century*, trans. Siân Reynolds, vol. 3: *The Perspective of the World*(Berkeley: University of California Press, 1982), 620.

Capitalism was evidently a difficult concept and/or historical process for Braudel to clearly define or place in time; it is this confusion that caught my interest and prompted my own further study here. Another historian, Richard Lachmann, similarly found the issue of defining capitalism and identifying its origins intriguing. In interpreting Braudel's latter definition, Lachmann infers that Braudel meant to imply that capitalism existed long before the period that Braudel studied, e.g., prior to the Christian Era; Lachmann writes that Braudel was mistaken in this claim. I, however, believe that Lachmann has misread Braudel.

Braudel's oblique definition of capitalism in his second volume is remarkably prescient and in fact broadly consistent with Lachmann's own analysis of when and how it emerged. Genuine confusion like this suggests that these definitional issues are more than mere quibbles. Braudel made a pivotal point when he noted that while trade and commerce were rooted far back in history, this trade had "only occupied a narrow platform of economic life. How could one possibly take it to mean a 'system' extending over the whole of society? It was, nevertheless, a world apart, different from and indeed foreign to the social and economic context surrounding it."[4] That context to which he referred was feudalism, and Braudel was defining capitalism in terms of the demographic, geographic, and economic space that it occupied, though not in terms of what it was or how it functioned. Implicitly Braudel was using the notion of capitalism as a system to mean a system of governance, in the sense that it could not be considered a system of governance unless it was in fact used for the governance of the bulk of the economic relations in the society, physical territory, or population. There could be trade, as there had been since pre-Roman times, but if neither capital nor labor was available for hire in markets, then one can speak of trade only as a minor activity existing alongside a largely self-sufficient feudal system, and not as a capitalist system. In this, Braudel seems to me to be reasoning like a political scientist and to be persuasive. Unfortunately he has little follow-through on this insight in his three volumes, as they have little to say about the governance of capitalist relationships or indeed about government. And these issues are anything but settled. Hernando de Soto adopts the same view that Lachmann attributes to Braudel, and it is indeed a pivotal part of the argument in his recent and influential book, *The Mystery of Capital*, which I take up in the next chapter.[5]

Braudel's analysis implies that capitalism had to displace feudalism, the prevailing system in Europe in the 15th century, to emerge as a system of governance. Trade, commerce, and production under feudalism were based on reciprocal, long-term relationships between people of very unequal power and wealth, intent on maintaining near self-sufficient manorial units of production and distribution, supplemented by barter. Trade in goods and services could take place in a feudal context, but land was not normally for sale and labor was typically tied to the land

[4] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 2, 239.

[5] See de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*.

in a set of feudal obligations, e.g., serfdom. Even Lachmann essentially echoes this analysis of feudalism

> Advances in knowledge and in the projection and organization of power coincided with the advent of capitalism. Manorial lands, immobilized by the overlapping use and income rights of peasant cultivators, aristocrats, clergies and monarchs became private property that could be improved and used according to the calculus of the single investor.[6]

Capitalism's emergence depended on alterations of the prevailing institutional frameworks, which allowed land to be bought and sold like goods and services and labor to be free to work for wages instead of feudal dues. In effect, frameworks were adapted to allow markets to play a much larger role in setting limits on as well as facilitating economic activity, and the incentives were likewise established so that it made sense to work and save to improve one's lot in life. The increased mobility of land and labor elevated the importance of markets and trade, thus shifting relative power away from landowners and toward the captains of trade and then industry; the emergence of capitalism was thus a political and social as well as an economic transformation. And each transformation depended upon corresponding innovations in the processes of governance; the societal changes required the development of more specialized and more competent forms of administration, while the emergent markets needed rules and regulations to function effectively, as well as a legitimate political authority to authorize, administer, and modernize them as needed.

Since feudalism was the prevailing social system the world over in the 15th century, historians have long been interested in how and why capitalism first emerged in Europe rather than China, India, Japan, or the Ottoman Empire. They have also been interested in why capitalism was exported so successfully to certain "European offshoots"[7] (e.g., Australia, Canada, New Zealand, and the United States) during this same time period (1400–1800), and much less successfully to other colonies, e.g., in Latin America. Why was not capitalism adopted by any of the leading, non-European empires of that era or exported to most of the European colonies? And why would it be exported to many other colonies with less success, for example, in Africa and Latin America? Questions such as these have been addressed from political, economic, social, and technological points of view. I seek to ask these same questions from the vantage point of political economy, employing the framework explained in the previous chapters to knit the economic, administrative, and political aspects into a single, albeit highly simplified, narrative. My key objective is to show that the notion of capitalism as a system of political economy can help us reinterpret some familiar data. My method is to take well-understood, detailed history and simplify it into a model of capitalism's development. Inspired by Braudel's work, I illustrate certain broad uniformities in capitalism's displacement of feudalism.

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[6] Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 6.

[7] This term comes from Angus Maddison.

Why Europe?

Europe did not start from a position of much higher incomes or larger markets than China, India, or the Ottoman Empire, though it did have certain geographic advantages and may also have had a greater technological reservoir upon which to draw.[8] There were no large differences in average incomes among these countries at the time,[9] and China and India even had larger markets as well as some advanced technologies. The major difference appears to have been that Europe had favorable geography, first in the sense of many navigable waterways as well as natural boundaries and, second, in the sense that it had few resources that lent themselves to exploitation by forced labor, such as the mining of precious metals or the production of sugar, and thus less favorable conditions for creating the repressive systems that would be established in many colonies, as we will see in Chap. 6. All had adopted feudalism as a cheap form of government where reciprocal relationships and barter minimized the need for cash, but only Europe had circumstances favorable to moving beyond feudalism and toward capitalism in the 16th–17th centuries, circumstances I briefly list here.

Rising incomes after the scourge of the Black Death early in the 14th century made it possible to reestablish a more complex, more interdependent way of life. All of Europe had the good fortune to benefit from the renewal of commerce and the revival of learning that came with the reopening of trade in the Mediterranean and the reanimation of the trade routes over the Alps and through to the North Sea. The rediscovery of ancient texts during the Renaissance and the rediscovery of Roman law not long thereafter, added greatly to its stock of intellectual capital. In addition, after 1519 most of Europe had the good fortune to benefit from an opening to new learning with the Reformation and then the Enlightenment. The historical legacy of a Roman Empire, Christianity as a common faith, and Latin as a common language for the elite, created the basis for a common culture that gradually accepted increased freedom of inquiry and expression, including experimentation that would develop into the scientific method.

Rising incomes and populations created new economic opportunities outside the manorial system, and the latter began to break down in favor of markets. There was much less reason for feudal lords to try to obstruct this process than there might have been had European economies been strongly attached to the type of forced labor found in the mines or sugar plantations of the western hemisphere (or what is now Indonesia). Feudal oligarchs with landed estates could sell some of their land and did so with increasing frequency.[10] Since the rich as well as the poor stood to

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[8]See David Landes, *The Wealth and Poverty of Nations: Why Some are So Rich and Some So Poor* (New York: W.W. Norton, 1999); Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: Development Centre of the Organisation for Economic Co-operation and Development, 2001), Figs. 1–7.

[9]Angus Maddison, "The Millennium—Poor Until 1820," *The Wall Street Journal*, January 11, 1999.

[10]Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 2, 49–51.

gain from increased factor mobility (i.e., mobility of land and labor) it was easier for governments to promote productivity through broad scale provision of public goods such as roads, law enforcement, and even universities, than if their societies had been characterized by self sufficiency or forced labor.

Aside from the economic goal of rising out of their poverty, the Europeans had another good reason to try to improve their lot in life: political survival. They faced an existential threat from the east and another from the southeast. The Europeans were not initially the foremost military power in their region, far from it; they faced an existential threat from the central Asian steppes, another from the Ottomans to the south, and yet another from internal conflicts within. Externally, the Ottoman Empire was such a powerful neighbor in the 16th century as to threaten a European takeover well into the seventeenth. Along with this external threat, the Europeans faced an internal threat of self-destruction, seeming to spend much of their energy and wealth making wars among themselves in ever changing alliances. The stakes were very high; there were an estimated 300–500 political units in Europe in 1500 and the number had been winnowed to about 40 after the settlement of the Napoleonic wars in 1815, and then to 25 by 1900.[11] Political entities that were too small or too weak to be adequately armed disappeared unless they had one or more protectors, as was the case for Luxembourg. This warfare was hugely expensive, given the very low levels of income prevailing at the time, and was accompanied by rapidly rising national indebtedness and risks of bankruptcies. Britain later became a leading example of this great national indebtedness in the 18th century; it borrowed heavily as it rose to achieve commercial, political, and naval supremacy, not just in Europe but on the world stage.

In the short-term the political and military competition among the states must have seemed wasteful, but in the long-term perspective it created continuing pressures on societies as they tried to stay independent, gain scale, and above all improve their performance. It was this perspective that led Lachmann to title his book *Capitalists in Spite of Themselves*. The creation and refinement of an extremely abstract system of governance was not the work of exceptional planners, such as Colbert in France; it was the unintended consequence of many incremental improvements by many people trying to improve the performance of their respective societies. Those who fell behind paid a price. Hostile takeovers frequently led to the execution of some of the former leaders of a losing entity, so there were continuing pressures for innovation and adaptation. This in turn created an incentive for all governments to take some care to avoid excessive plundering of their subjects. The fact that no single country won out meant that these pressures continued for centuries. Jones points out that this situation was unique in the world, as most areas were governed by empires.[12] From a contemporary viewpoint one can also say that the European experience was much like the shakeouts that regularly take

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[11]Charles Tilly, as cited by E.L. Jones, *The European Miracle*, 2nd ed. (Cambridge: Cambridge University Press, 1987), 106.
[12]Ibid., 104.

place when new industries start out in a capitalist context with many small units, only to be squeezed down to a drastically smaller number as competitive pressures force the weaker to exit or be taken over by a stronger rival.

Out of this constant infighting there emerged a series of political innovations that came together as a new form of governance called the state, giving Europe a critical advantage moving forward. Unlike the empires of the day, where one people or nation used its powers to tax and physically oppress others for its own benefit, or the familiar monarchs who could exploit their own subjects because they claimed to rule by divine right, the emergent state was based upon a political bargain where the rulers promised justice through the rule of law in return for loyalty and taxes. Paradoxically, by limiting the powers of the heads of state, their regimes gained increased legitimacy, which in turn allowed them to borrow money and enlist troops for what came to be "national," as opposed to dynastic, causes. Increased borrowing power coupled with increased citizen loyalty created remarkable possibilities to project military and political power to defend the homeland and perhaps make hostile acquisitions of weaker cities and states as well. States made war, and war made the states, as the saying goes.

Successful transformations of the feudal systems required a gradual but fundamental shift in power away from feudal landowners toward the rising commercial classes and then, much later, toward a broader, more democratic electorate. Those who gained economic power through commerce gained political power as well. European feudalism, like its counterparts elsewhere, was characterized by a very unequal distribution of land and power, as shown in Fig. 4.1. To develop a market economy where the underlying institutions did in fact guide decentralized decisions in the direction of the common good, these institutions would have to be shaped to serve far broader interests than those of the lord of the manor. Feudal societies were not blessed with a strong middle class, and there was no obvious way to create one quickly or easily. Indeed Europe lagged behind some of its offshoots in this critical respect, i.e., Australia, Canada, New Zealand, and especially the United States, in the creation and/or strengthening of its middle class and, much later, in its march toward democracy as we will see in Chap. 7. Still, Europe would have to reduce the power of those who owned the castles and chateaux if the institutional incentives of its societies were to move away from the interests of its powerful landed elites and toward the needs of its less fortunate masses. Obviously any such redistribution of wealth required the mobilization and deployment of political power over long periods, if only to facilitate the growth of commerce, creating new and better paying jobs in cities and towns, thus drawing labor away from the feudal domains.

But while this power shift away from feudal landlords was gradual, the corresponding movement toward capitalism was anything but. This chapter argues that the transformation of European society from feudalism to capitalism cannot be adequately understood as one based upon a smooth process of market expansion and capital accumulation. It argues that the emergence of capitalism is best understood as a process that occurred in the context of intense political and military competition that placed acute pressures on the various European political entities, most of which would eventually succumb to that pressure and be subject to hostile takeover by a stronger neighbor. It also agrees with Lachmann and others who stress the role of human agency; good leaders could make do with less than optimal circumstances while poor ones could fritter away their advantages, for example, on over ambitious military adventures, as happened to Charles I and Philip II of Spain. The pressures of feudal lords to maintain their privileges were often sacrificed to the rising needs of the emerging European states for more tax revenues to fight to maintain their independence, and perhaps to enlarge their territory as well. There were incentives to convert reciprocal obligations to cash based transactions.

At the same time, this intense international competition also created some common interests within the respective states. In the event of a hostile takeover the domestic elites stood to lose their privileges and perhaps their lives to boot; contributing to national war efforts, even if it meant giving up an amount of economic and thus political power, was a way to have a share in a bigger pie. In this intensely competitive context, European feudalism was initially displaced by a relatively simple form of capitalism, or proto-capitalism that emerged in city-states, initially in Italy and then in a belt of cities running along what is now the Franco-German frontier.[13] These city-states were able to exercise more initiative than other European cities because they were relatively shielded by distance from France and Spain, the key power centers in the early years, though neither of these powers occupied the full territory associated with the states in more recent times. As a result of their greater independence these city-states had more freedom to experiment with their systems of governance; and with improved governance some but not all of these cities were able to provide superior social and physical infrastructure and would prosper accordingly.

But this relative prosperity of city-states was temporary. With the exception of Venice, these city-states were unable to achieve the scale or scope to protect themselves from powerful neighbors, and did not have the time to develop full-fledged capitalist systems. They had what I would think of as proto capitalist systems, by which I mean an evolutionary form of economic and political organization that had some of the institutions of capitalism, such as double entry book-keeping and bills of exchange, formal legal systems with courts to adjudicate disputes, and various political authorities characterized by limited capacity to mobilize and even project power, typically based upon mercenary forces. They lacked the scale in terms of territory and population to have the wealth to afford the necessary bureaucracy, public works and military power that would ultimately be needed to protect their territory as armies got bigger and therefore much more costly. I use proto-capitalism not to denote specific institutions or processes of governance so much as a system in which the political authorities were too weak to be able to establish and maintain a monopoly of coercive force to provide a genuinely secure environment for business transactions. The economic agents needed insurance against government failures as much as against market failures. Most of the early leaders of these proto-capitalist

[13] In this my argument is much like Richard Lachmann's; see Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, Chap. 3.

city-states lost their political freedom and were bypassed by other centers of power based in larger political units, i.e., the newly formed states. Roughly similar forms of proto-capitalism also emerged elsewhere, for example, in India, and also failed to form the nuclei of successful capitalist states. The institutional basis of feudalism was broken down, but that of capitalism was not fully built.

The Feudal Economy

What were the essential characteristics of feudalism, and how was it displaced? In 1200 Europe's key factors of production were land and labor; today's more complex capital goods hardly existed. Agriculture was the primary source of employment and income, land was the primary source of wealth or capital, and land was typically controlled by feudal lords and worked by tenants. Control of land (but not necessarily ownership) was acquired in return for feudal obligations to a lord, "magnate," or perhaps member of royalty. As a result, the land was typically owned by one party, the lord, controlled by a second, the vassal, and worked by a third, the tenant or serf. Those who worked the land and even those who controlled it had little incentive to improve it. At the same time, neither the land nor much of the labor could be readily reallocated through markets. Much of production was for consumption on the manor or household where it was produced, and the prevailing institutions were strongly committed to maintaining the distribution of power embedded in the status quo.

Traditional commerce existed as a subsidiary if profitable activity in the predominantly feudal social system. The two economic systems co-existed, the first rural and dominant and the second largely in cities and towns, and each had its own system of governance, as suggested by Fig. 5.1. For proto-capitalism to emerge,

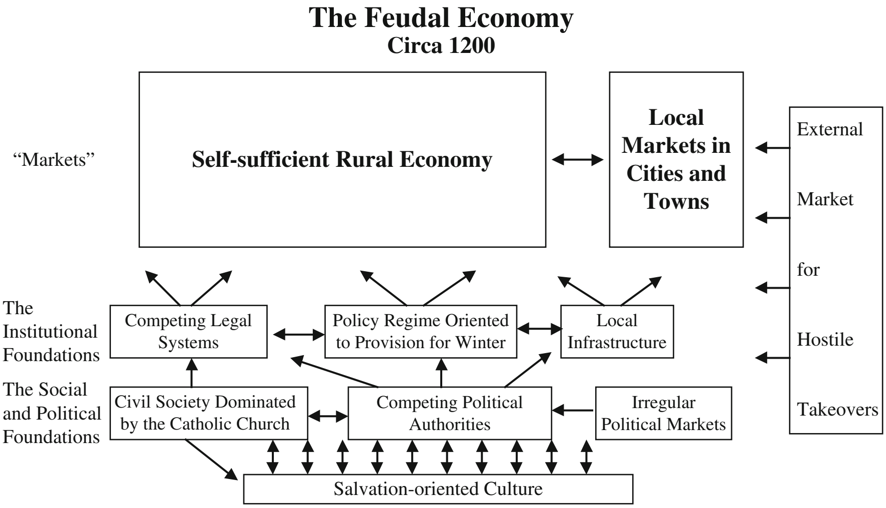

Fig. 5.1 The feudal economy, circa 1200. Source: Bruce R. Scott

cities and towns had to achieve a considerable measure of self-governance from prevailing feudal authorities. A revival of trade would raise urban incomes and give cities added financial leverage with respect to the rural sector, but much change was needed for such a revival to take place.

At the time, factor markets were immobilized by feudal obligations, and product markets were highly limited by transport costs, tolls, and banditry. Except for luxuries or along waterways, most goods were produced and consumed in a trading radius of perhaps 10 miles. Markets were guided neither by central plans nor indeed by prices, but by well-established social relationships. Prices were based upon traditional norms of fairness, not supply and demand. The leading "corporations" of the time were guilds, and guilds were expected to store supplies to avoid shortages and to restrict supply if prices threatened to fall below fair values. The feudal manor was the leading "vertically integrated" producer of the time, but largely for its own use; it shipped a modest surplus to market to pay for needed inputs not internally produced. In this context there was not a lot of opportunity to employ additional capital to launch new products or achieve increased economies of scale.

For commerce to expand its share of economic activity, capitalists had to be free to try new things while at the same time they had to be protected from predators, both personally and in terms of their property. In the Middle Ages Europe was characterized by some 300–500 local political entities, each providing varying degrees of "protection" within its domain. Although these local feudal governments were typically weak when it came to external defense, they could easily work like protection rackets, preying off the commerce in their territory more than protecting it. At a minimum they could and did erect toll stations along highways and waterways. Cities could also provide some protection to would-be capitalists, as could guilds, but typically only within a very small radius. Obviously transport risks and costs could be reduced if there were a geographic "hegemon" to eliminate the toll stations, improve the roads and provide protection over a much wider area. This would only come in the 17th century with widespread adoption of the state as a framework for societal governance with a much larger scope, including but not limited to the economy. Nevertheless, even within feudal societies, it was still possible for incomes to rise.

From Feudalism to Proto-capitalism

European incomes recovered gradually from about the year 1000 onward due to improvements in law and order and a revival of trade, first within Europe and then in the Mediterranean region, as Islamic control of the latter diminished. Florence was an early leader in manufactures, and the Medicis created a network of banks to finance that and other trade. With direct access to the sea, Genoa and Venice were early leaders in transport and trade, vying for leadership in maritime commerce. Braudel saw these and other cities as the engines of growth

> . . . it was the medieval city . . . which, like the yeast in some mighty dough, brought about the rise of Europe. . . . The town consolidated its future with its roads, its markets, its workshops, and the money that accumulated within its walls. Over a very wide area the

> crucial move was made from a domestic economy to a market economy . . . the towns were beginning to tower above their rural surroundings . . . This was a “great leap forward”, the first in a series that created European society and launched it on its successful career.[14]

Cities such as Florence, Genoa, and Venice took the initiative by giving economic freedom to merchants and entrepreneurs while investing in market-expanding infrastructure and institutions. This was the road to capitalism, or at least proto-capitalism. And yet in terms of economic prosperity, as indicated by population growth,[15] these proto-capitalist cities were far from world leaders. Europe was not the leader in terms of large-scale urbanization until near the end of the 18th century. Indeed, the world’s largest cities were primarily in Asia, as shown in Table 5.1. Constantinople, on Europe’s doorstep, was far larger than any European city as late as 1700; the Ottoman Empire had more large cities than Europe in the 12th century and was still on a par as the 16th century opened. How to explain this puzzle? While cities did afford important economies of scale, most of the lead cities in non-European countries in these early years were political capitals, and thus derived much of their income from taxes rather than the production of wealth. Within Europe, on the other hand, most of the early lead cities were commercial, as shown in Table 5.3. This contrast suggests that political capitals were not comparable engines of economic growth, but rather were in significant measure consumers of wealth. To extend Braudel’s metaphor, the yeast was therefore in the capitalist system itself, and the city was where the right combination of ingredients was to be found.

Once a country got ahead it almost always stayed among the leaders, even centuries later. Early Spain and Portugal would be telltale exceptions. But at the city level, there could be dramatic decline, suggesting that whatever economies of scale a city might have were hardly sufficient to ensure its future. This was true within Europe as well as in the Ottoman Empire and India. Even large cities were not

Table 5.1 Cities with populations of 100,000 or more

	1300	1500	1600	1700
European				
Number of cities	2	3	11	12
Largest city	Paris 228,000	Paris 185,000	Paris 245,000	London 550,000
Non-European				
Number of cities	13	17	21	22
Largest city	Hangchow 432,000	Peking 672,000	Peking 706,000	Constantinople 700,000

Source: Adapted from Tertius Chandler, *Four Thousand Years of Urban Growth: An Historical Census* (Lewiston, NY: St. David’s University Press, 1987)

[14] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 3, 3:94.

[15] Given the paucity of income data prior to the 1800s, population growth has long been used as an indicator of economic prosperity, with population decline as an indicator of the opposite.

large enough to protect themselves from takeover by a hostile neighbor. In addition, their governance could be compromised from within by a coup. Thus, the threat of takeover, whether external or internal, was a critical challenge to long-term success, as indeed was the evolution of successful governance within the city walls. Italy was Europe's early leader in urbanization, but this urbanization took place within the context of city-states; Italy did not achieve statehood until the 1860s. Italy's early lead at the city level was thus based not just upon the accumulation of economies of scale, but also upon an array of key societal changes that encouraged growth while limiting the chance of takeover.

The Renaissance began in Italy with a commercial revival based upon increased trade in the Mediterranean Sea, with connections across the Alps that linked it to what would become Belgium and the Netherlands. As commerce and manufactures flourished, agriculture, though still by far the dominant activity, declined in relative importance. Transport costs declined thanks to better ships, improved systems of navigation, the use of armed convoys to protect cargo vessels, and improved relations with various key cities in the Eastern Mediterranean, including the Venetian takeover of Constantinople. In addition, overland trade routes to Asia allowed Asian luxuries to reach Europe. With reduced transport costs and important new sources of supply, there were increased opportunities for gains from specialization and trade.

With rising incomes, feudal obligations were gradually abandoned in favor of cash transactions. As feudal obligations were phased out, land could be bought and sold, and both land and labor were gradually freed to search for better employ. These new "factor markets" permitted a reallocation of land and labor, as well as a greater role for self-interest in the development of the land, contributing to further rises in incomes. The spread of markets permitted increased capital mobilization; large estates were broken up, and much of the common land was privatized. The privatization of land encouraged the clearing of additional acreage as well as increased investments in that now privately owned land, i.e., increased mobilization of previously underutilized capital. Privatization also turned former tenant farmers into a land-less proletariat, allowing the new landowners, as the new capitalists, to reap most of the increased returns.[16] And it was not long before new financial instruments, including sovereign debt, also aided in mobilizing capital, albeit often for military purposes. As described thus far, this seems like a story of largely market-led growth within Europe.

Braudel, like many others before him, seems to agree with this story, attributing the rise and decline of various European cities largely to changing patterns of trade. The reopening of the Mediterranean had allowed leading Italian cities, especially Genoa and Venice, to prosper from mastering these new trading opportunities. Florence led in manufactures and banking and, like a number of smaller German cities, prospered from trade routes across the Alps all the way to the mouth of the

[16]See Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*.

Table 5.2 World's largest 25 cities in selected years

	Year						
	1200	1300	1400	1500	1600	1700	1800
Region							
Italy	1	2	2	3	5	3	1
Other Europe	2	3	4	2	4	4	8
China	8	9	9	8	6	6	5
India	1	3	1	4	3	3	4
Mid-East/N. Africa	9	5	6	5	4	4	2
Other	4	3	3	3	3	5	5

Source: Adapted from Chandler, *Four Thousand Years of Urban Growth*, 478–485

Rhine. Thus, in spite of its comparatively small overall size, Italy had a very disproportionate share of the world's largest cities between 1500 and 1700, as shown in Table 5.2.

With the discovery of a trade route around Africa, trade with Asia shifted away from the caravan routes through the Levant to the Atlantic coast, and to the advantage of Portugal, Spain, The United Provinces, and England. This shift in economic activity toward the Atlantic seems consistent with a smooth process of market-led growth. But, as Richard Lachmann has pointed out, description is not the same as analysis. In his view, the shift in trade routes away from the Mediterranean is only a partial explanation of the subsequent shift in economic growth away from the Italian city-states; another part of the causality lay in the fact that the Italian cities had initially gone only part way in their capitalist transformation and would thus fall far behind.[17] In Lachmann's analysis the Italian cities had embraced proto-capitalism, which did not necessarily lead on to the real thing.

Advances of Proto-capitalism

Proto-capitalism was a very considerable advance relative to feudalism, and was itself not easily achieved. If one were to return to the sporting analogy used in Chap. 2, proto-capitalism might be likened to intramural sports as organized by a college or university. Some of the rules were informal, and the referees might be amateurs or simply the most senior of the players. It was semi-organized sport, but a lot better than just standing around throwing a ball and a lot safer than a free-for-all. The economic engine of proto-capitalism was the placement of increased amounts of capital at risk in the expectation of a satisfactory, "risk-adjusted" return. The increased opportunities for specialization and trade, and especially for long distance trade, carried greatly increased risks. They required the exposure of capital for much longer time periods in ships and cargoes of increasing value. Thus, the

[17] Ibid., 44.

investor's exposure went up enormously along with his opportunities. It was essential to spread those risks at any given time, but it was also essential to create a legal vehicle in which risks could be managed through time.

In terms of capacity to deploy capital through time Europe created three advantages relative to the Ottoman Empire.[18] First, as Timur Kuran describes, European inheritance laws were more flexible. They allowed for unequal inheritance, in amount as well as in kind, and thus for passing control of business assets from one generation to the next. In contrast, inheritance in the Ottoman Empire was governed by Koranic formula, which specified the exact proportions that each relative was to inherit, with the men receiving more than the women. This inevitably meant splitting the inheritance more widely and the need to include more partners to finance a given venture. With more partners, deaths were obviously more frequent.[19] The difference was of crucial importance, because in the early years almost all businesses were organized as partnerships. When a partner died the partnership had to be reorganized. Whereas in the European case a single son or other designee might inherit the father's share, in the Ottoman case the shares had to be divided according to formula and had to be paid in cash. There were good reasons for these rules, first, to protect the rights of women in a male dominated society and, second, to try to distribute the wealth more broadly. But at the same time, these rules made it exceedingly difficult to create businesses that could achieve and sustain large scale. The significance of this handicap would become more apparent as time passed.

The Europeans gained a second advantage when, in the 16th century, they created the joint stock company as a legal vehicle that carried on even in the event of the death of an owner. Notable examples of these included the Muscovy Company established in 1555 and the Levant Company in 1581. Most Muslim countries had no such option in their legal systems until the 19th century and thus were at a huge disadvantage when competing with European traders. The Europeans could have larger, more stable firms and could thus gain economies of both scale and scope on their Muslim rivals. Since Ottoman law allowed ethnic minorities to use their own courts and laws within the empire, Muslims within the empire might also be at a disadvantage with respect to their Greek or Jewish neighbors.

The Europeans also gained a third set of advantages in the spreading of risks. In Venice, the state owned the merchant ships and supplied the navy to protect them. But in most other cases, investors needed to split the risks of ship and cargo ownership as well as insure against some of those risks. In order to split the cargoes, secure insurance, and collect for the cargo at its destination, there was the need for formal contracts enforceable in some known locale and under some set of rules or laws. The Genoese were leaders in sailing from the Mediterranean to the

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[18] Timur Kuran, "The Islamic Commercial Crisis: Institutional Roots of Economic Underdevelopment in the Middle East," *The Journal of Economic History* 63, no. 2 (June 2003): 414–446.

[19] Ibid.

Low Countries, and by the 14th century they had established such a system, with third-party underwriters.[20]

Banks were another institutional approach to the diversification of risk in Europe; they could offer greater security to savers than they were likely to achieve on their own (much smaller) loan portfolios. With greater security, there was more incentive to save and to put those savings to work in the form of a loan, instead of keeping them "safe" at home in the cookie jar or other hiding place. Cities could also increase the rate of saving and capital accumulation by offering their own promissory notes, based upon their "credit rating" and eventually their taxing power.

Various European borrowers learned the value of establishing strong credit ratings and reaped the rewards through their proto-capitalist regimes. As Braudel observes, "Interest rates fell almost continuously from the fifteenth to the eighteenth centuries."[21] The rates charged for the best commercial loans declined from about 10% in the 12th century to about 5% in the 15th, and the Italian cities plus Antwerp led the way.[22] Such low interest rates could only make sense if the expectation of repayment was very high, based either upon the cost of a damaged reputation to the borrower or the prospect of debtors' prison. In contrast, princes and kings often paid much more because it was possible for them to repudiate their debts, and a number had done so. Thus, even before full-blown capitalism, Europe was creating advantages through new market enhancing (deepening) institutions, and these advantages tended to cumulate as their firms carried on through time and grew ever larger.

Italy Initially Led the Way

A number of Italian city-states were early leaders in the proto-capitalist era. What were the dynamics of their population growth, and why would Italy lead within Europe? As Table 5.3 shows, in 1300 Italy had 4 of Europe's 12 largest cities, all located in the north, reflecting this region's lead in the Renaissance. In 1500 Italy had 6 of the top 12. And in 1600 Italy still had five of Europe's nine largest cities, though only two were located in the north.

As these numbers suggest, and as Lachmann has pointed out, there was a crucial shift in the composition of the lead cities from commercial centers toward political capitals. In 1300 commercial cities had 9 of the top 12 spots, but only 7 in 1500, and only 2 by 1600. Why were city-states with proto-capitalist economies able to flourish at least for a time in northern Italy, but not in Britain, France, Germany, or Spain? And why were all of these Italian commercial centers except Venice eclipsed

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[20] Florence Edler de Roover, "Early Examples of Marine Insurance," *The Journal of Economic History* 5, no. 2 (November 1945): 174–176.

[21] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 2, 2:386.

[22] Sidney Homer and Richard Sylla, *A History of Interest Rates*, 3rd ed. (New Brunswick, NJ: Rutgers University Press, 1991), Chart 2, 140.

Table 5.3 Population and rank of the 12 largest cities in Europe, and other large cities for reference, 1300–1700

1300	1500	1600	1700
Commercial cities			
(3) Granada 90,000	(4) Milan 89,000	(5) Seville 126,000	(10) Milan 113,000
(3) Seville 90,000	(5) Ghent 80,000	(7) Milan 107,000	
(5) Genoa 85,000	(7) Florence 70,000		
(6) Milan 60,000	(7) Granada 70,000		
(6) Florence 60,000	(10) Genoa 62,000		
(8) Cologne 54,000	(11) Bruges 60,000		
(9) Rouen 50,000	(12) Bologna 55,000		
(9) Bruges 50,000			
(12) Ghent 42,000			
Capital/port cities			
(2) Venice 110,000	(2) Venice 115,000	(2) Naples 224,000	(1) London 550,000
(11) London 45,000	(3) Naples 114,000	(3) London 187,000	(3) Amsterdam 210,000
	(12) Lisbon 55,000	(4) Venice 151,000	(4) Naples 207,000
		(8) Palermo 105,000	(5) Lisbon 188,000
		(10) Lisbon 100,000	(6) Venice 144,000
			(8) Palermo 124,000
Capital cities			
(1) Paris 228,000	(1) Paris 185,000	(1) Paris 245,000	(2) Paris 530,000
	(5) Moscow 80,000	(6) Prague 110,000	(7) Rome 138,000
	(7) Prague 70,000	(9) Rome 102,000	(9) Moscow 114,000
		(11) Madrid 80,000	(11) Madrid 105,000
		(11) Moscow 80,000	(11) Vienna 105,000

Source: Adapted from Chandler, *Four Thousand Years of Urban Growth*

before the Industrial Revolution, leaving Italy a laggard within Europe until the mid-20th century?[23] The answers do not seem to lie in the realm of economic analysis but rather in the realm of political science. There were in fact two crucial political issues at the time with explanatory power. One was whether a city had the freedom to develop its own institutions as it wished, and the other was whether it could establish a system of governance that would allow it to take advantage of such an opportunity.

In the 15th century northern Italy existed in something of a power vacuum; the Papal States were to the south, a nascent France to the West, and the Holy Roman Empire to the north. These three powers periodically invaded and fought each other as well as the Italians. The power vacuum gave modest-sized cities such as Bologna, Florence, and even Siena the opportunity to secure a measure of autonomy. With it they could hire their own mercenaries and finance their defense budgets by taxing

[23]Naples remained one of Europe's major cities, but it was a political capital; and Milan was a major commercial center even after it lost its independence.

their residents and their commerce. In this context, the promotion of commerce had strategic importance as it would for the larger states as well.

Proto-capitalism was based upon cities achieving a considerable measure of autonomy to chart their own courses. Given the relative autonomy secured by the aforementioned power vacuum, Italy was able to pioneer in the reintroduction of the city-state, and it was in these city-states that republican government, and the proto-capitalism that this more accountable system enabled, flourished for a time. While these experiments with republican government were plagued by the threat of takeover from powerful nobles within as well as rivalries with nearby cities, they had the advantage of being able to hold their political authorities accountable for their actions. The alternative was some sort of hereditary royalty, i.e., rule by a prince or, on a larger scale, by a king. The advantage of the former system of governance was in avoiding the arbitrary use of power that was associated with absolutist regimes.[24] But if republican government was an advantage it clearly was not sufficient to assure a long-term economic lead. Cities, republican or not, lacked a sizeable economic base to afford the increasing demand of military protection.

Venice seems to have been the archetypal republican success, first as a city and then as a city-empire. It was able to turn its peculiar geographic circumstances to its political as well as its economic advantage. Well before the end of the first millennium, the small islands in the Venetian lagoon banded together to form a federal government with successive dukes responsible to a small oligarchy of merchants, a form of government they were able to maintain for almost a 1000 years. Venetian success was based upon two kinds of freedom: freedom from domination by a nearby feudal power and freedom from arbitrary and indeed despotic government within the city. These freedoms were used to good economic advantage, and Venice would be the richest place in the world for about two centuries.[25]

A number of Italian cities, including Venice, hired civil servants to administer their institutions, instead of relying upon volunteers as the Greeks had done more than a 1000 years earlier. As a result, they could develop more specialized and sophisticated physical and especially social infrastructure that would help increase the trading radius. Thus, this proto-capitalism differed from its predecessor in having much more developed institutions and markets, including capital markets based on bank credit and state credit (Fig. 5.2). At the same time, this proto-capitalism differed from later capitalism in its smaller scale, less stable governance, less secure monopoly of violence, and thus lesser ability to protect and sustain a continuous process of institutional modernization. In addition, some of these cities, notably Venice, were unwilling to accord citizenship to newly annexed areas, thus mitigating the need to offer justice in return for taxes and loyalty. Charles Tilly has

[24] Bradford DeLong and Andre Schleifer, "Princes and Merchants, European City Growth before the Industrial Revolution," *Journal of Law and Economics* 36, no. 2 (October 1993): 671–702. DeLong and Schleifer found a strong positive correlation between accountable government and economic performance, but two of their strongest cases were Britain and The United Provinces, which were governed as states and not just cities.

[25] See Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 2.

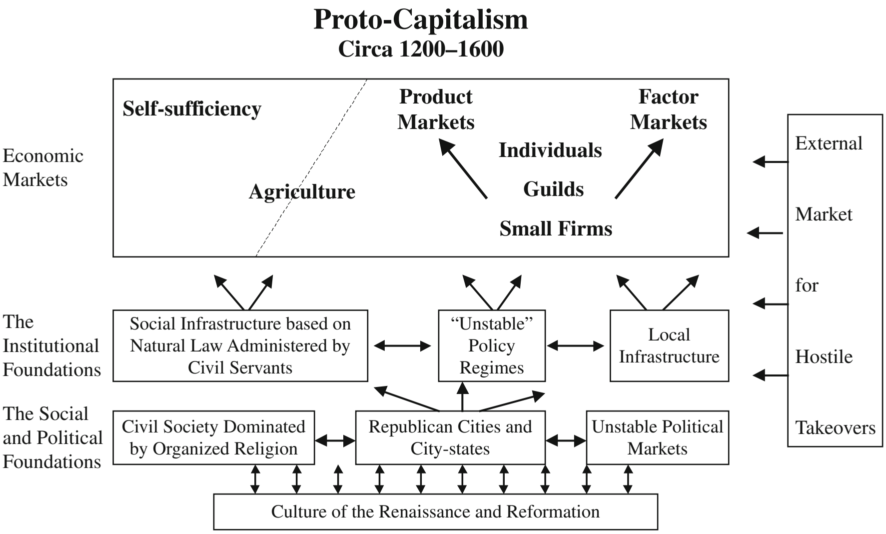

Fig. 5.2 Proto-capitalism, circa 1200–1600. Source: Bruce R. Scott

pointed out that such weaknesses, taken together, prevented these early developmental leaders from mobilizing the resources needed to protect themselves from "hostile takeovers," especially by foreign conquest.[26]

Prior to 1600, "commerce" in most of Europe, as elsewhere, was more or less like intramural sports, as noted above. There were rules, but they could be informal, and while there might be provision for external enforcement, it would not necessarily be by a powerful enforcer. For example, since Genoa had pioneered in trade between the Mediterranean and the Low Countries, its customs were often used for settling disputes in the latter countries, with local judges calling upon Italian traders to advise the court as to their customs.[27] But merchants often had to discipline their own, much like when players of an amateur sport prohibit someone who egregiously breaks the rules to participate in subsequent games. Thus, proto-capitalism still had a variety of governing authorities, both nationally and still more internationally, though hardly a codified system.

Subsequent decline came from misgovernment and the failure to consolidate power on a large enough scale to face the rise of stronger powers in the Papacy, France, and Spain. This argument is much like that for the consolidation of an industry (such as autos, steel, or semiconductors) as it becomes more capital intensive. If commerce was a growth industry of the time, so was territorial acquisition. Defense required bigger and bigger armies, hence greater scale. A city-state could

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[26] See Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 46.

[27] de Roover, "Early Examples of Marine Insurance," 198–200.

borrow money to pay for troops, and some city-states pioneered in "sovereign debt" financed by their tax revenues, but scale was still critical. Portugal needed British help to maintain its independence from Spain, and the Netherlands needed even more help from those same British to maintain their independence from France. But the price for that help had to be weighed against the cost of lost autonomy.

City-states could provide the freedom to facilitate technical and commercial innovation as well as the infrastructure to support it, but typically they had neither the culture of continuous modernization nor the combination of power, reach and stability of the later states. As a result, most of the leaders of the proto-capitalist era did not continue as leaders of the succeeding capitalist era.

Florence was an archetypal example. Florence was an early leader in the development of manufactures, commerce, large firms, and double entry book-keeping.[28] In addition, the Medici family was able to create a trading and financial empire with important links all the way to Britain, and in the 14th century their wealth allowed them to buy control of Florence and, from time to time, of the Papacy as well.[29] Florence might have been the base for a takeover of much of northern Italy and for the start toward an Italian state. But when the Medici rose above the law in the 15th century, Florence experienced internal strife, including an interlude of government by an anti-business cleric named Savonarola, and its economic base and administrative capabilities eroded. In addition Florence failed when it made war upon Pisa to try to establish direct access to the sea, in a project designed by Leonardo and partly managed by Machiavelli. It also failed in its attempts to reach a stable accommodation with Milan. Had it succeeded, it might have been the capital of a Tuscan state or even a northern Italian state, but instead it experienced economic decline. While its population was about 70,000 in 1500, this number fell to 65,000 in 1600 and to only 61,000 in 1800. Florence was a model of proto-capitalist success, but also a model of how the misrule of arbitrary government could contribute to a loss of autonomy and to an economic eclipse.

Why would Venice (before its eventual decline) come to eclipse the other northern Italian cities in terms of wealth and power? Genoa, its rival, might have been a survivor. Surely it had the capital to have tried to become a colonial power in competition with Portugal. Instead, Genoa came under the hegemony of Milan. Milan was in turn overrun first by France and then Spain under Charles V, thus losing its independence to one of the most predatory of the absolutist regimes. In the event, Genoese bankers lost much of their money when Spanish monarchs repeatedly defaulted on their debts.

Venice was the only city in northern Italy to remain an administrative capital throughout the period, so it was alone in retaining the power to tax both an extensive commercial system as well as an agricultural hinterland. It was a "city-empire" for centuries, at times controlling "terra firma" as far inland as Bergamo and the Alps,

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[28] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 3, 3:128.

[29] Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 80–81.

various Aegean Islands, and, for a time, Constantinople. Venice was also a leader in institutional innovation; it created a stable model of accountable government, and it constructed its famous arsenal to build ships, owned large merchant ships and auctioned space on them, and sent its merchants to the Levant in armed convoys. In addition, it required all trade to pass through Venice so that it could be taxed to support the city's armed forces as well as other expenses.[30] In 1374, it banned its banks from speculation in commodities and, from 1403, required them to hold one-third of their assets in government debt and to be subject to bank examinations.[31] Early in the 15th century, Venice became the richest city in Europe, with a budget comparable to those of France, England, or Spain.[32] Thus, it might be appropriate to think of Venice as the first successful model of capitalism, even though its city-empire lacked the strength to resist the advances of the Ottoman Empire.

From Commercial Capitals to Political Capitals

By 1700, incomes and economic power had shifted from early commercial leaders such as Florence and Siena to political capitals such as Naples, Palermo, and Rome, as well as other capitals. Capital cities, with or without a port, held 11 of the top 12 spots in the list of Europe's largest cities. Loss of status as a co-capital of the Austro-Hungarian Empire was devastating, as seen in the case of Prague following its defeat in the Thirty Years War (1618–1648). Seville suffered a similar eclipse as political power in Spain was consolidated in Madrid. But the most dramatic failure was probably that of Antwerp, a commercial city without an adequate army.

In the early 1500s, Antwerp was the connecting link for much of Germany as well as the Atlantic economy. In 1526, its population was about 46,000. Then, as it became the entrepot for Portuguese spices from Asia and other commodities from Brazil, its population shot up, reaching 105,000 in 1568, granting the city status as the leading European city.[33] In fact, Antwerp has been called the implicit model for Adam Smith. It had free markets, not just for goods and services, but also for labor and capital. In addition, it did not adopt the mercantilist policies and institutions of its neighbors, most particularly the Dutch, and it had virtually no military forces. Consumers were thus given their due. However, the bankruptcy of the Spanish crown, which at the time controlled Portugal, disrupted Antwerp's great source of wealth and its finances. Subsequent invasion by a Spanish army bent on punishing

[30] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 3, 3:125.

[31] Homer and Sylla, *A History of Interest Rates*, 98.

[32] Braudel, *Civilization and Capitalism, 15th–18th Century*, vol. 3, 3:120.

[33] Population data from Tertius Chandler, *Four Thousand Years of Urban Growth: An Historical Census* (Lewiston, NY: St. David's University Press, 1987), 170.

it in connection with the Dutch war of independence led to its sack, a period of religious persecution under the Spanish Inquisition, blockade by the Dutch, and loss of more than half of its population in the next 30 years. By 1600 it was not even among Europe's top 12 cities (Table 5.3).

The meteoric rise of Amsterdam, Lisbon, and London in the 17th century, plus the continued growth of Paris, provide examples of the success that could accrue to port cities that were administrative capitals protected by strong armed forces. Capitalist success thus depended upon both scale and scope. The rather modest requirements of minimum effective scale were suggested by Portugal and the Dutch Republic. In 1600, each had about one million inhabitants, which was far larger than any of the Italian city-states other than Venice, but far smaller than England, France, or Spain. The Portuguese and the Dutch had to fight for their independence from the same great power, Spain. Portugal briefly succumbed, but the Dutch succeeded, thanks to the strength of their economy, which allowed them to mobilize an army and navy that were able to achieve a stalemate with Spain, hold off France, and fight successive wars at sea with Britain. But the story of "Italy" was quite different.

Capitalism Developed in Cities, but Cities Were Not the "Yeast"

Why were most of the cities in northern Italy largely eclipsed by political capitals by1600 and certainly by 1700? The usual analysis is that they lost their place primarily due to the shift of trade routes to the Atlantic Ocean. While the major trade routes did indeed shift, leaving them at a disadvantage in terms of time and thus cost, was this enough to explain what happened? Why did not either Genoa or Venice become a colonial power? If additional scale at home was a key, why did not at least Venice acquire this scale and project sea power from it, as Portugal and the Netherlands were able to do? And, if the Atlantic was the key, why would neither France nor Germany become major maritime powers during this era? And why were both Portugal and Spain eclipsed in spite of their favorable geographic location, great port cities, naval power, and early imperial successes?

While cities were indeed where the new capitalist culture first flourished, these cities needed adequate scale as measured by tax revenues in order to protect themselves from hostile takeovers by stronger neighbors, an argument put forth in the previous section. The Italian cities failed to consolidate as a state, and they were occupied piecemeal by Habsburg Spain, France, and the Papacy, thus eliminating their administrative autonomy. Some of the German cities were also constrained by the power of the Habsburgs and others by Prussia, thus depriving them of the autonomy they had previously used to forge a Hanseatic League to regulate their northern trade. Later, many would be absorbed by Prussia.

The new leaders of the European economy were not cities but states, and notably the United Provinces, England, and France. The Dutch, for example, were able to raise government revenues almost sixfold between 1600 and 1670 as they rose to the position as the economic hegemon of Europe while fighting for their independence from Spain.[34] Obviously this required a great expansion of public debt, which depended in turn upon maintenance of a good credit rating. To mobilize power effectively over an extended period of time a society had to continue to modernize its institutions to maintain their effectiveness. Except for Venice, the cities of northern Italy failed to mobilize enough power to protect themselves from hostile neighbors while also modernizing their institutions. They lost their autonomy, their tax revenues, and the means to mobilize unusual amounts of capital, and thus the power to continue large-scale innovation, for example, by establishing colonies in parallel with Portugal, Spain, or the United Provinces.

Although power was necessary for large-scale development, it was not sufficient. Constantinople was the largest and most powerful of what might have been considered the European cities of the proto-capitalist era. As the seat of power of the Ottoman Empire, it had the opportunity to head a system with a great geographic advantage astride the sea lanes from the Black Sea through the Aegean and as far as Morocco. Its empire gave it great economies of scale and taxing power, although its very expanse made it difficult to govern. But the Ottomans were absolutist rulers of a conglomerate empire. While they were ahead of Europe in practicing religious toleration, their legal system remained rooted in Islamic law. And, while the Ottomans were far ahead of Europe in creating an elite professional corps of celibate, Christian janissaries to administer their empire, this very corps was being downgraded through acceptance of marriage and admission of Muslims. Moreover, the Europeans were coming to recognize the need for professional administrators to replace their regional tax farmers, who still enjoyed their hereditary rights. The Turkish elite administrative corps was succumbing to nepotism and corruption at much the same time that those in Europe were improving in their professionalism. In addition the Ottomans did not share the European experience of the Reformation and the Enlightenment, failing to adopt the new ideas of how to use the powers of a state to improve economic performance. Similar evaluations could be made about the more or less autonomous Ottoman fiefdoms headquartered in Cairo, Fez, and Marrakesh, as well as the Persian, Indian, and Chinese empires.

"Italy" had the cities and the wealth to be a world-class powerhouse in 1600; the rest of Europe had distinctly secondary status when it came to the world's largest cities all through the formative period of capitalism, as suggested by Table 5.2. But cities could not sustain their lead without liberal government and larger size. Tyranny could bring decline to any lead city, whether in Italy, the Middle East, North Africa or further East. Moreover, cities lacked scale and scope to provide adequately for their own defense in a region characterized by near continuous warfare. Thus, while the clear world leader in the development of cities in the fourteenth and fifteenth centuries, Italy lost its early lead in relative incomes, and indeed, it stagnated for three centuries, as suggested by Fig. 5.3. Italy would not be unified as a state

[34] See Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, Table 5.4, 168.

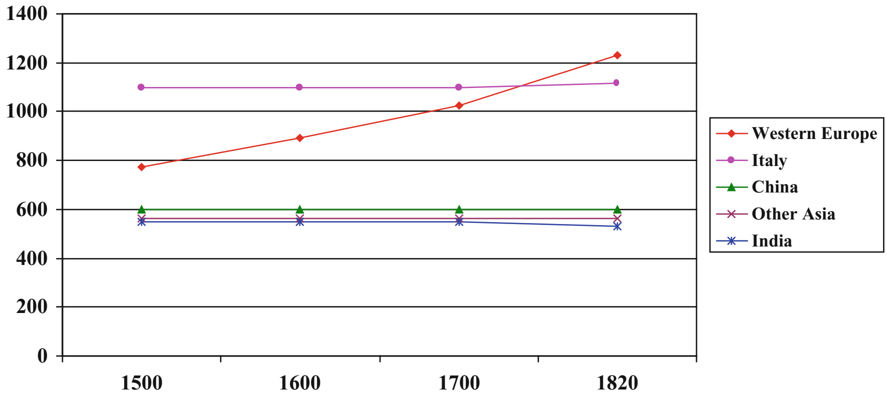

Fig. 5.3 GDP per capita, selected European regions and countries, 1500–1820 (1990 in international $). Source: OECD (2001), Maddison Angus, *The World Economy: A Millennial Perspective*, p. 246, www.theworldeconomy.org

until 1860, by which time its early lead had long since been completely lost. At the same time, the Ottoman Empire, lacking more liberal governance, would similarly show little overall improvement in incomes in spite of its great cities, a pattern much like that in China and India.

More than increased size, the key change enabling capitalism (and economic growth) was one of political economy, and again it was apparent in the cities. As capitalism took hold in Europe, Europe's largest cities were shifting from commercial centers to capital cities hence political and administrative centers, as shown in Table 5.3. This made Europe seem at least more superficially like the Ottoman and other empires. But the European governance systems were different from those of any of the empires in the sense that the state was responsible for providing market frameworks based upon a rule of law in return for taxes and loyalty. It was not merely a seat of power where an elite resided while exploiting its hinterland. For that European state to provide appropriate frameworks as technologies and societal priorities changed, it had to have both the power to govern and bring about change as well as the accountability to bring changes that continually related individual costs and benefits with those of society as a whole. Unlike Braudel's metaphor, where the city's yeast might rise gradually from one generation to the next as its markets became more sophisticated, capitalist systems required the presence of a strong political authority to protect them from foreign takeover as well as to provide the political power for continuing domestic modernization. Any such concentration of power risked creation of a tyranny and the unleashing of arbitrary behavior that would inhibit economic development. Capitalism has been rooted in political economy since its origins, not in economics alone.

Cities were the locale where economic progress was most evident, and where the dough did indeed rise, as in Braudel's metaphor. But cities were more like the kitchens where the dough was mixed and baked than like the yeast itself. In a short-term, or quasi-static, sense, the yeast that made things grow lay in the capitalist system, where more liberal and accountable political governance provided institutions such that the economic actors had the freedom to innovate, customers had the freedom to accept or reject those innovations, and competition sustained continual innovation. Productivity and incomes—the dough, so to speak—were rising because successful innovations were transforming raw materials in ways that added value for customers. Like yeast, the market system needed time and stable political conditions to do its work, and, also like yeast, it needed heat as a source of energy to support such a rise. In Europe that heat came from competition among political entities. If there was a new ingredient in the recipe, perhaps it was the concept of return on investment, i.e., that there should be a return on capital as well as labor. This was a key conceptual break with the past and particularly with organized religion within Europe, not least within Italy. But critical to it all was the yeast or better yet the recipe for a capitalist system, which was only possible with the establishment of stable political governance providing market frameworks as modified by political authorities, which were accountable to a rule of law.

In order to emerge and survive over time, capitalism as we know it required continuing modernization in the processes of governance as well as in economic institutions. In addition, success would require harnessing the new ideas being developed through science, and the new technologies that they were spawning. In Europe, almost continuous warfare helped guide the minds of its elites and/or political leaders toward these economic goals, however, indirectly.

Sociopolitical Systems of Governance Provided the "Yeast" for Capitalism, via Many Recipes and Cooks

The yeast stimulating the rise of capitalism was sociopolitical change, specifically the establishment of a system of governance that allowed the free movement of land and labor and thereby the birth of factor markets, which, as E.L. Jones notes, were requisite for any market economy.[35] The establishment of such a system occurred among different sets of people, at various speeds, and in various locations throughout history; the yeast was, in a sense, applied by different cooks following different recipes in different kitchens. To illustrate, consider the works of three groups of historians: Karl Polanyi's study of the enclosure period in 14th-century England[36]; Daron Acemoglu, Davide Cantoni, Simon Johnson, and James A. Robinson's joint study of the invasions of European cities by French Revolutionary forces[37]; and

[35] Jones, *The European Miracle*, xiv.

[36] Karl Polyani, *The Great Transformation* (Boston: Beacon Press, 1944).

[37] Daron Acemoglu, Davide Cantoni, Simon Johnson, and James A. Robinson, "From Ancien Régime to Capitalism: The French Revolution as a Natural Experiment," unpublished manuscript, forthcoming in *American Historical Review*, March 2007, http://www.people.fas.harvard.edu/

Richard Lachmann and E.L. Jones's respective studies of the emerging nation-states of western Europe.[38] Although these works deal with different geographical units, time periods, and historical events, they all link the establishment of a more liberal sociopolitical system with the rise of a capitalist economic system. Moreover, all three indicate the importance of human agency in the process, particularly that of the reigning political authority.

In *The Great Transformation*, Polanyi documents the significant social upheaval caused by the seizure of open fields by the feudal lords of rural 16th century England, as they effectively privatized previously common property. These lords petitioned Parliament to allow them to pursue "improvement" even at the price of "social dislocation," and overtime they privatized more and more of the land.[39] This meant that, on the one hand, the enclosure movement created the opportunity to develop land, increase crop yields, and thus increase personal profit; on the other hand, it destroyed the villages of the peasants who had lived there, displacing them from their traditional jobs, homes, and ways of life. As Polanyi recounts, "the lords and nobles were upsetting the social order, breaking down ancient law and custom, sometimes by means of violence, often by pressure and intimidation."[40] Such socioeconomic transformation had at least two far-reaching economic effects. First, privatizing land, even by means of legislated theft, meant that land became a commodity able to be bought and sold. Second, dislocating peasant farmers from their previous agricultural employment meant that they were able to pursue new economic opportunities, opportunities which unfortunately were rare at the time and existed predominantly with the help of the Crown as it attempted to slow down the enclosure movement and its painfully transformative effects.[41] In this way, the sociopolitical changes of the enclosure movement increased the mobility of land and labor and thus led—over many years, and even centuries—to the establishment of the factor markets necessary to capitalism.

Robinson and his colleagues' paper on "The French Revolution as a Natural Experiment" similarly demonstrate the impact of sociopolitical change on economic opportunities. By studying the rapid economic progress of certain European cities directly following their invasion by the armies of Napoleon in the early 19th century, Robinson and his colleagues trace a strong correlation between institutional change and economic growth. They argue that "the institutions of the *ancien régime* did indeed impede capitalism," because the occupational immobility of all non-privileged groups (i.e., all except the monarchy, the aristocracy, and the church) as well as the strict hierarchy governing both social and economic relationships

~jrobins/researchpapers/unpublishedpapers/jr_frenchrevolutionAHR.pdf. Hereafter referred to as "Robinson and his colleagues."

[38] Jones, *The European Miracle*; Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*.

[39] Polyani, *The Great Transformation*, 36.

[40] Ibid., 37.

[41] Ibid., 40.

fundamentally precluded any sort of voluntary exchange in free markets.[42] The impeding institutions, however, were undermined in many German and Italian cities upon invasion by the armies of the French Revolution. Napoleon's forces often imposed sociopolitical reforms that effectively liberalized these feudal cities, such as "the reform of the administrative system, the enactment of written legal codes, the restructuring of agricultural relations, the abolition of guilds, the emancipation of Jews, and the secularization of church lands."[43] Robinson and his colleagues observed that those cities where these reforms remained, even after the French forces left, experienced greater growth than otherwise. As with Polanyi's account of the enclosure movement, a new, more liberal sociopolitical system of governance was established and, in turn, gave rise to a new capitalist system of economic governance. In this case, however, the change was more rapid as the "yeast" of capitalist institutions was applied immediately and completely with military force.

Lachmann's and Jones's respective works also show how sociopolitical change led to economic change, echoing Polanyi's argument but in the context of multiple Western European nations, instead of simply England, and at the larger geographical unit of nation-states, instead of rural towns. Lachmann corroborates Polanyi in explaining that throughout Europe, "as land was freed of peasant rights, peasants were proletarianized. A majority of English peasants lost their farms and became wage laborers in the 16th and 17th centuries."[44] However, he moves from the level of feudal elites seizing property primarily for private gain, focused on by Polanyi, to the level of state actors imposing taxes for national gain. Wars abounded during this time period, as the nations of Western Europe developed into powerful regimes. Chief among the concerns of monarchs building these regimes was how to raise the resources necessary to support their armies and navies. Cash raised from nobles and merchants carried political consequences; monarchs often had to make "political agreements" such as title distributions and policy concessions, both of which might undermine their national sovereignty in the name of enhancing their international sovereignty.[45] A more palatable option was popular taxation of not only land, but also goods, as both bore no such political threat. Jones develops a similar argument, describing how kings saw the establishment and subsequent taxation of commerce "as a means of obtaining and securing revenues greater than might be acquired from feudal dues and various forms of land tax."[46] It was in fact this option of facilitating organized trade in order to tax it that led to fundamental sociopolitical reform. Jones explains that as the state taxed peasants more, they were forced to raise extra cash either by selling more produce and engaging in more trade or by selling their

[42] Acemoglu et al., "*From Ancien Régime to Capitalism: The French Revolution as a Natural Experiment*," 1.

[43] Ibid., 14–15.

[44] Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 6.

[45] Ibid., 105.

[46] Jones, *The European Miracle*, 89.

land and finding other sources of labor.[47] Thus, as Lachmann puts it, "state taxation concentrated resources at a national level, creating (mainly through military procurement) the initial markets for capitalist enterprises."[48] While such social change was undoubtedly painful for the peasants involved, as noted by Polanyi, it, nevertheless, freed up land, labor, and thereby the factor markets of a capitalist system. Thus, we again see that social change toward the establishment of more liberal economic institutions, all stimulated at the political level, led to the rise of capitalism. Moreover, we see a powerful role for coercion in each of these examples, e.g., in parliamentary takings of commons in the United Kingdom, with redistribution to the aristocracy; in suppression of German institutions of federalism by the French army; and in the use of the coercive powers of the state to tax small landowners. In each case, the notion that capitalism could grow smoothly through voluntary bilateral transactions is hardly a fair or lucid analysis of what happened.

The examples provided by the works of Polanyi, Robinson and his colleagues, Lachmann, and Jones together demonstrate that the rise of capitalism in Europe was preceded by the establishment of a more liberal sociopolitical system of governance, applied in different geographies and in different ways. Moreover, they highlight how crucial the "cooks" were in each case, specifically, the political authorities who forced social and thereby economic change, as well as the individuals—elites, merchants, and peasants alike—whose human energy was harnessed by this newly regulated context to achieve capitalist growth. Thus, as in Chaps. 2, 3, and 4, we again see that it is not impersonal market forces but rather personal human agents, and particularly those with political authority, that drive the creation of capitalism as a system of economic governance.

From Proto-capitalism to Capitalism as We Know It

The transformation of European economies from proto-capitalism to modern or self-sustaining capitalism (Fig. 5.4) required that European elites undergo a shift in world-view that would legitimize if not prioritize material progress, learn to promote economic development through systematic modernization of their institutions, and create an institutional vehicle powerful enough to achieve those modifications and likewise powerful enough to ward off neighboring powers. The first two of these changes came with the Enlightenment, the third with the creation of the state as a vehicle for large-scale political and administrative mobilization and administration (as seen in the examples above). Together they constituted a revolutionary societal transformation. No smooth process of economic growth proved able to bring the needed changes. War, revolution and executions of the sovereign were part of the process, even in the Netherlands.

[47] Ibid., 86.

[48] Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 97–98.

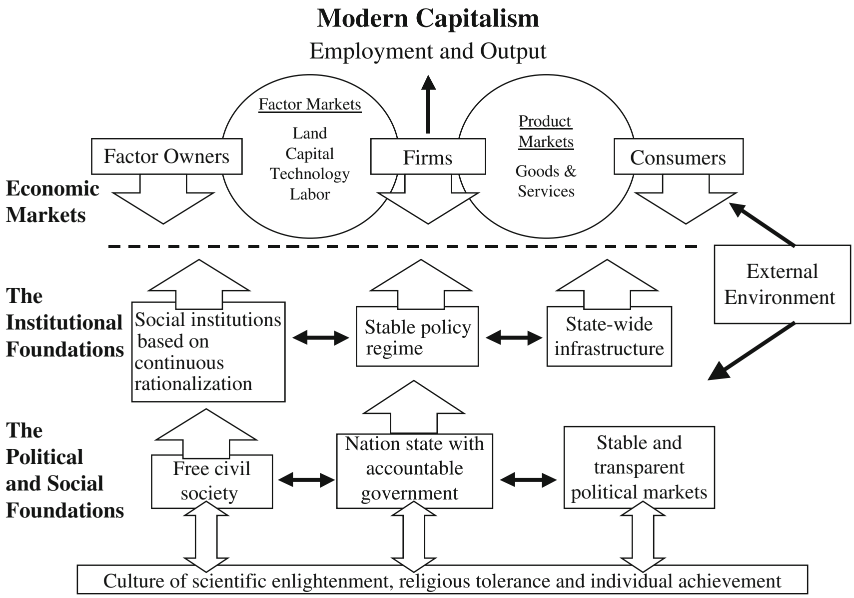

Fig. 5.4 Modern capitalism: Employment and output. Source: Bruce R. Scott

Once created, this new order of things would empower political leaders to promote territorial aggrandizement, domestic repression, and institutional modernization. There were great risks as well as great opportunities. And the key changes were more in the social and political foundations of the capitalist economies than in the markets themselves, a point of fundamental importance that was often overlooked in literature on such economic development until quite recently.

The Reformation brought a reduction in the power of the most powerful and, arguably, the most conservative institution of the time, the Catholic Church. It was followed by the Enlightenment, which included the notion that material progress was indeed a legitimate focus of human aspiration. In this new context the state could be the vehicle for continuing institutional modernization and thus a force for material progress. At the time, however, the concentration of power in the state was basically driven by military considerations. Since war was expensive, and often took more than half the government budget, material progress was also of prime importance as a way to increase war-making capacity. The political imperative for the full transformation to capitalism, including a dynamic process of continuous institutional modernization, came first from the need for additional resources to finance warfare, and only secondarily to raise the consumer's standard of living. Early mercantilist economic strategies were a way to promote economic power, a fact that is sustained by the previous section's examples, though apparently overlooked by a famous analyst of the period, an observation to which we will return.

The Reformation, Enlightenment, and Rise of the State

As important as the political imperative for economic development was, it would not lead to full acceptance of the liberal economic institutions needed for capitalism without prior ideological acceptance of them, as achieved by the Renaissance, the Reformation, and the Enlightenment. In 1519, Martin Luther's manifesto launched the Reformation, challenging the temporal power as well as the doctrinal monopoly of the Catholic Church. While initially a challenge to the sale of indulgences to help fund the construction of St. Peter's in Rome, Luther's protest escalated until it sundered the Church's monopoly control of the "market for personal salvation." Due to that monopoly the Church was the most powerful institution of its time, capable of successfully challenging and even ex-communicating kings. While Martin Luther's critique of Church practices and doctrine was doubtless a considerable achievement, the fact that he was not summarily burned at the stake, as a number of earlier Church critics had been, was due in large measure to his good fortune in receiving the protection of one of the electors of the Habsburg emperors, a protector that neither the Pope nor Charles V wished to cross.

The Reformation was an immensely important step toward a change in worldview, but it led only part way, i.e., from monopoly control of the market for personal salvation to organized oligopoly. The next century was one of warfare over confessional issues in the competition for share of the confessional markets, while at the same time the various churches were in accord to persecute atheists and suppress their writings. It was not until after the Thirty Years War, in 1648, that toleration for competing religions became an established European norm, and it took yet another century to establish tolerance for agnosticism and atheism as well. Thus, free civil society, including freedom of speech and the press, were rarities before the 18th century. Capitalism would precede these freedoms by a century or more.

The writings of Copernicus, Galileo, Kepler, Newton, and others ushered in an era of Enlightenment in the 1600s as experimental method and logical reasoning were applied to general understanding and then to the attempt to master the surrounding universe. However, these and other early scientists were careful not to challenge the supremacy of theology, let alone of organized religion, on pain of death. Beginning about 1670 and becoming more widespread after 1700, philosophy and science were gradually allowed an autonomous existence, i.e., they were liberated from religious control.[49] It was a "revolution" in which reason and empirical proof were allowed to enjoy academic autonomy alongside deductive reasoning from the scriptures and other ancient texts. The potential implications for the governance of human affairs were momentous.

Modernity begins when men develop a sense of their own competence, when they begin to think first that they can understand nature and society, and then that they can control nature and society for their own purposes. Above all, modernization

[49] Jonathan Israel, *The Radical Enlightenment: Philosophy and the Making of Modernity, 1650–1750* (Oxford: Oxford University Press, 2001).

involves belief in the capacity of man by reasoned action to improve his physical and social environments. It means the rejection of external restraints on men, the Promethean liberation of man from control by gods, fate, and destiny.[50]

In 1600 European laws were based upon norms established by the Greeks, the Romans, particular religious authorities, common law, and local custom. In this context, "man discovers law, he does not make law."[51] And, in the medieval context, kings, parliaments, and other notables were all engaged in the "discovery" of natural laws and, as the saying went, "Law makes the King."[52] However, as Huntington observes, all of this would change, both in substance and process: "In seventeenth-century Europe the state replaced fundamental law as the source of political authority and with each state a single authority replaced the many which had previously existed."[53]

With the Enlightenment, laws came to be recognized as "man made," under the auspices of a state, which exercised the powers of "sovereignty" over a geographic area, and kings "were the authors and makers of the laws and not the laws of the kings."[54] Societies could modify their laws and other institutions so as to "control" their environments and steadily improve or modernize them. Indeed, the state could be employed to assist in harnessing the power of capital in the pursuit of measurable progress in this world. It was a new option, conferring enormous power upon a relatively small number of people who were "agents of the state" and not the agents of organized religion.

To establish the supremacy of the state, the Europeans had to rein in the power of organized religion along with that of the great barons. This included curtailing the power of the ecclesiastical courts, Church landholdings, and Church tithes relative to the taxes of the crown. It happened in different ways in the major countries.[55] In France the Catholic Church remained the official church and a very powerful institution, but much of the power to make ecclesiastical appointments as well as much of the revenue was delegated to the local nobility. At the same time, the Estates General met for the last time (prior to the Revolution) in 1615, thus effectively disenfranchising the clergy and the nobility. Parliaments were also suspended in other continental countries with similar effect.[56]

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[50] Huntington, *Political Order in Changing Societies*, 99.

[51] Ibid.

[52] Edward S. Corwin, *The "Higher Law" Background of American Constitutional Law* (Ithaca: Cornell University Press, 1955), 27, as cited in Huntington, *Political Order in Changing Societies*, 100.

[53] Huntington, *Political Order in Changing Societies*, 98.

[54] James I, "The Trey Law of Free Monarchies," in *The Political Works of James I*, ed. Charles Howard McIlwain (Cambridge: Harvard University Press, 1918) quoted in Huntington, *Political Order in Changing Societies*, 103.

[55] Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 93–146.

[56] Huntington, *Political Order in Changing Societies*, 103.

In England things developed quite differently. Henry VIII nationalized the Catholic Church in 1535 after failing to receive a papal annulment of a barren marriage. By confiscating most Church land he greatly increased the wealth and power of the throne. To entrench this power shift, he gave some of the confiscated land to Catholic barons, thereby ensuring that they would think twice before attempting an official "reestablishment" of Catholicism. The sale of former Church lands became a major source of revenue for Elizabeth I and James I. James would get into trouble when he tried to establish a centralized regime in England like that of his "brother" in France, and his son Charles I would be executed for attempting to establish the notion of rule by divine right. By 1689, England had long since established centralized authority in the government and not the Church, but its "Glorious Revolution" was consummated by a signed agreement with William of Orange, a process that made clear that sovereignty was to reside in Parliament and not the crown.

According to Huntington, the rise of the state brought three huge changes to European governance: the rationalization of authority, the differentiation of structures, and the expansion of political participation.[57] Rationalization meant the centralization of authority (typically in the person of a king), the simplification of structures, the elimination of overlaps, and the establishment of clear lines of hierarchical authority. The differentiation of structures meant establishment of separate structures for differing activities, for example, the separation of a customs service from an inland revenue, public health or police service. Political participation meant elected representation to the organs of government.

Here, in this third change of political participation, Europe took a very different tack from the United States, a tack that is often overlooked when people think of the United States as a model for development. The first European states were established in the 17th century when there was little if any representation of the "electorate." Kings ruled by divine right in France, Portugal, Spain, and Sweden, for example, while legislative representation was eliminated as the century went on.[58]

In contrast, the United States, as Huntington points out, was set up with political institutions based upon 16th century Tudor England. In the Tudor era governors represented the crown, but legislatures were elected. And the legal system was based upon natural law, British common law, and local customs, with much of it administered by local notables who served as unpaid justices of the peace.[59] So while Britain was consolidating power, first in the hands of the Stuart kings and then, after two revolutions, in the hands of Parliament, the colonies kept their representative institutions and, in 1787, rejected the notion of a concentration of power either in the executive or legislative branches. In this sense, the American Revolution was a rejection of the sovereignty of Parliament, and thus a war of independence. In societal terms it was a conservative upheaval and a dramatic contrast with the French Revolution a century later. Moreover, Huntington emphasizes that the US

[57] Ibid., 93.

[58] Ibid., 93–139.

[59] Ibid.

Constitution provided for a separation of its governmental functions into three branches, not for a separation of powers as is often thought. The three branches still had fused or overlapping powers.[60] Thus, the US Supreme Court could overrule Congressional legislation, while English courts recognized acts of Parliament as by definition the sovereign law of the land.

If the United States was unique in maintaining branches with overlapping functions and a strong role for common law and custom, it was also unique in having a "balance of powers" and thus a less centralized system. When others took the US Constitution as a model, they often saw and adopted this form of government. But this may not always have been appropriate because, as Huntington points out, the US circumstances were almost unique. The American settlers colonized a land where the native inhabitants were being killed off by newly imported diseases and by local actions. With neither dukes nor magnates with private armies protected by moats and walls, nor an established church that might control a quarter or more of the land, the United States did not have to confront powerful entrenched rural interests prior to the Convention at Philadelphia in 1787. The delegates did have to deal with wealthy, rural southerners, but they decided to finesse the issue of slavery lest it torpedo their chances for effective union. Other countries, then as now, confront such entrenched opposition and thus must face the fact that the state needs power to overcome such opposition if it is to modernize institutions. When the time came for the United States to confront this problem it required full mobilization of such powers and ultimately civil war.

Of greater contrast with Europe (and with the United States for that matter) was the Ottoman Empire. While European states were consolidating their territory, they were also centralizing power and rationalizing and professionalizing the bureaucracy. The Ottomans were doing the opposite. Not coincidentally, it was in the second half of the 16th century that the institutional structure of the Ottoman Empire showed signs of breakdown. The feudal gentry had once been the backbone of the Ottoman state in the sense of supplying troops and leadership in times of need; now the Sultans began to replace it by using professional "slave" troops. The feudal cavalry lost its importance as more specialized regiments were used, while the standing army increased rapidly along with the cost of maintaining it. At the same time, the sultans began to incorporate many of the feudal holdings into their respective domains. The sultans leased these lands out and eventually leases became life-long and then heritable. But, instead of owing service, the new owners became tax farmers, bidding for franchises and then squeezing their tenants for as much revenue as possible. The result was a new, influential class that intercepted much of the revenue flowing from the peasantry to the government and that was corrupted in the process. At the same time, what had long been an exemplary bureaucracy based on an elite corps of Christian slaves (called janissaries) was dismantled. Whereas in the past the janissaries had been committed to celibacy and thus to service, now they were allowed to marry and soon were attempting to pass their powers on to their heirs.

[60] Ibid., 105ff.

In addition, others were allowed to buy jobs, thus corrupting the recruitment and promotion process. Over time, the Ottoman Empire became a collection of regional satrapies that were less and less responsive to the influence of the Sultans. As the Sultanates became weaker, regional leaders became more powerful. And, to make matters worse, the Turks failed to achieve the accountability of their regime; the Sultans were increasingly the captives of their own palace officials.[61]

The European State

Europe took centuries to create its states and, in some cases, it took another century or more to establish the accountability of its rulers. Plato's notion of a polity with shared interests was eventually translated into that of a state with a "general will" in the 17th century. Today we think of states as "nation-states," but they were not necessarily so when they started. Britain was a merger of England and Scotland in 1707, following the English absorption of Wales. Both Scotland and Wales had separate parliaments as well as different laws and languages, but both were integrated into the British state, where inhabitants of all three areas shared equal rights of citizenship. Ireland provides a useful contrast. It was initially occupied by Britain in 1536, and reoccupied by force by Oliver Cromwell in 1651–1652, subdued again when William III of Orange defeated James II in 1691, and then treated as an occupied territory. About a million of its inhabitants were allowed to starve to death while British landlords exported foodstuffs during the great potato famine in 1844–1845. For centuries Ireland was treated as a colony, not as part of the British state. Spain, like Britain, was a merger of established societies with their own languages and parliaments. In fact, some Catalans still prefer their own language and some Basques still look upon Castille or Spain as an occupying power. Oddly, Germany and Italy were each identified with a "people" or nation long before they became nation-states.

While there is no hard and fast line of demarcation between a state and an empire, the latter signifies the domination of one people by another. Once a state was established, the notion of a national interest became a powerful unifying force that would be difficult for an empire to match. One could seek to use reason to promote a national interest, which was quite different from promoting the interests of the dominant group with little or no regard for those of subordinate groups.

The state was an institutional vehicle for territorial acquisition and consolidation, for making war, and for market development through the provision of public goods. The primary challenge to European political leaders was to protect their turf from powerful neighbors. Thus, Europe had only 3 years in the 17th century when there was not a war somewhere within its frontiers.[62] Wars required money, and

[61] Bernard Lewis, *The Middle East: A Brief History of the Last 2,000 Years* (New York: Scribner, 1995), 122–124.

[62] See Huntington, *Political Order in Changing Societies*.

there were economies of scale in financing military forces. Like many industries, Europe went through a dramatic consolidation of political entities, dropping from more than 500 in the year 1490 to about 28 in 1990.[63]

But it was not enough to create this new vehicle for the mobilization of political power; somehow that power had to be made accountable to the people that were governed. Consider two contrasting examples. The Venetians achieved accountability to an oligarchy that represented the islands in the lagoon, leaving the inhabitants of "terra firma" without a voice in government. Thus, Venice was a city-empire more than a state. The Dutch, in contrast, achieved a republic from 1588 to 1795, and for most of the period 1600–1800 were Europe's richest people (Fig. 5.5). Their wealth allowed them to be a real European state in the seventeenth and much of the 18th century, in spite of their small population. Accountability was thus necessary for statehood.

England, France, and Spain were the most likely political hegemons, but all three had difficulty establishing accountable government. England required two revolutions in the 17th century, the second assisted by a Dutch invasion. While the king became accountable to parliament in financial affairs, parliament was accountable to a very limited electorate during the formative centuries, at least by later standards. Even after the great political reform bill of 1832 only 3% of the British public had the vote, but this still made Britain the leader of political reform in Europe at the time. France would experience revolution in the 18th century and then enjoy near hegemony over Europe thanks to Napoleon's armies. It experienced difficulties in achieving governmental accountability almost to the dawn of the 20th century. In the end, parliamentary control of the purse became the mechanism to achieve governmental accountability to a domestic electorate.

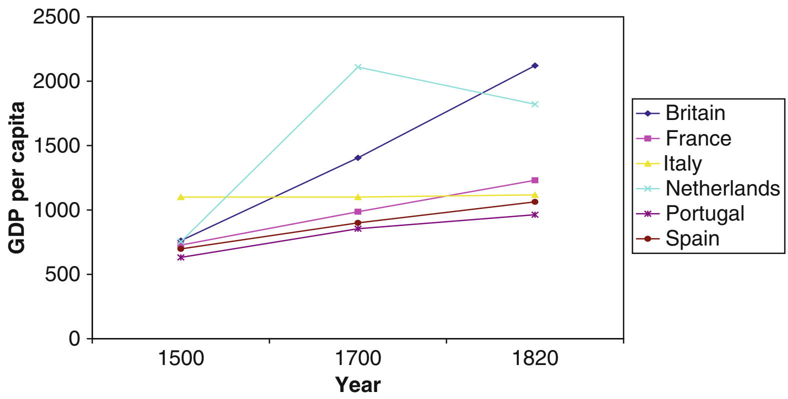

Fig. 5.5 Relative GDP per capita of selected countries, 1500–1820. Source: OECD (2001), The World Economy: A Millennial Perspective, p. 90, www.theworldeconomy.org

[63]Charles Tilly, as cited in Lachmann, *Capitalists in Spite of Themselves: Elite Conflict and Economic Transitions in Early Modern Europe*, 4, 46.

Other European states were subject to a more limited form of accountability during the formative years of the 17th and 18th centuries. They achieved legitimacy based upon an acceptable level of performance; continuing competition among rival states required that they generate incomes to pay taxes to finance war (as explained earlier in this chapter). This rivalry was controlled to a considerable degree by the creation of a "states system," where alliances would change to maintain a balance of power, thus preventing any one state from subjugating all of the others. Wars played a role in this process much like that played by economic competition in forcing a measure of accountability upon firms. Britain played a remarkable role in this system; its focus on maintaining a balance of power acted as an implicit antitrust policy for the continent. Without the threats of political competition and hostile takeover, Europeans surely would have had much greater difficulty constraining the enormous powers they had assembled in the various states that had both the right to tax and the right to exercise a monopoly on coercion to back up their demands.

Rivalry among states called for increased incomes to support military forces, and this caused states to try to promote economic development in agriculture, commerce, and technological innovation, for instance in the development of ships and weaponry. Britain was a particular case in point. With a much smaller population than France or Spain, it needed money to pay for weapons, mercenaries, and allies to maintain the power balance in Europe. In part to minimize the risks of military dominance at home, its policy emphasized naval power and the hiring of mercenary land forces as needed. Britain, France, the United Provinces, and Venice would each create mercantilist economic strategies for mobilizing extra economic power to support their state building. Tariffs were an essential way to pay the debt service that came from borrowing to support military adventures, though they also served to protect the development of nascent manufactures.

If hierarchical states played a key role in European development, limitations on hierarchies also played a key role. Absent the hegemony of a single church or state, technology was diffused and secularized throughout Europe. Clocks, for instance, transferred time-keeping from the monastery to the clock tower in the village, and the printing press did much the same for the production and distribution of books. And, thanks to continual competition among the states, most were open to inward migration of talent should it be persecuted in another state, as for instance the immigration of Jews from Spain, Huguenots from France, or "Belgians" from Antwerp, after the Spanish razed much of their city in 1576. Thus, political competition among states within Europe was a stimulus for continuing modernization, as it would be within the United States. In addition most of Europe, with Spanish and Portuguese territory excepted, would permit the mobility of capital and labor across borders, again a parallel with the United States.

Less Successful States and Empires

The state, where the inhabitants shared equal rights of citizenship, was a European rediscovery of a Greek innovation. Empires, where one group ruled one or more others, were the predominant form of territorial rule in the rest of the world until the mid-20th century. But some of the European societies were more successful in state-building than others. Britain and France are usually seen as the first two successful modern states, but the Dutch Republic was also an obvious success, if on a smaller scale, and Venice almost qualifies.

Spain was arguably less successful in establishing sustained statehood, economic development, and eventual capitalism. Under the Habsburgs, it would try to dominate Europe for more than a century, from the accession of Charles V in 1519, and nearly succeed on several occasions. Charles gained the Habsburg crown by outbidding his French rival, thus taking Spain far into debt. His ambitions were financed in considerable measure by wealth extracted from the New World plus additional borrowing, and he neglected to create the institutions and the policy regime necessary to promote domestic wealth creation. In this, Spain experienced difficulties not unlike those of some cases of modern nations with great resource wealth, for example, Nigeria, Saudi Arabia, or Venezuela. Since a large fraction of the gains from exploiting the New World accrued to the crown, it could maintain hierarchical control at home, denying power to its parliament and its business community alike. On the other hand, the crown was too weak to curtail the powers of its landed aristocracy. They had grown immensely powerful as they led in the re-conquest of Spain from the Moors. Large inflows of gold and silver into a stagnant economy and a stalemated political situation forestalled reform. Instead, Spain experienced the first modern inflation, rendering local agriculture as well as manufactures less and less competitive and thus reducing the incentives for entrepreneurial activity. Bankruptcy and economic decline gradually deprived Spain of its great power status following three bankruptcies in the 16th century. France then emerged as the leading power in the 17th century under Louis XIV and Louis XV, and Britain mobilized and helped finance one coalition after another to contain its power.

Portugal was also an early leader, thanks to the riches brought home from its empire. But it lost that position due in part to a Spanish takeover and in greater part to a failure to develop its institutions, industries, and commerce at home. Like Spain, Portugal failed to separate church and state until much later than Britain. Also as in Spain, the Inquisition was allowed to imprison and execute industrialists as well as less commercially inclined heretics. Portugal thus suffered the consequences of a culture that failed to establish the value of institutional modernization in order to achieve material progress in this world. Portugal's opening of trade routes to India and beyond did bring real competition to the spice trade and greatly reduced the income and power of Venice, but it did not lead to the rise of Lisbon as a world center. Part of the explanation lies in Spanish domination of Portugal from 1580 until 1640; Portugal simply was not allowed to develop its own interests as had Genoa and Venice. But even after it became independent and politically unified, Portugal was still unable to break free from its traditional economic and political relationships to free up resources for manufactures.

The example of Portugal demonstrates that natural advantages are not a sufficient basis for development. It takes the constant modernization of institutions to exploit such advantages and an effective state to mobilize the requisite power to sustain such modernization. Portugal created a state, but was unable to break free of religious domination for centuries. Culture and law enforcement matter, especially when law enforcement functions were partially institutionalized in powerful religious movements such as the Inquisition. The state does not exist apart from its institutions and the agents who administer those institutions on its behalf. Seventeenth-century Portugal's law enforcement was stymied by the Inquisition supported by a rural aristocracy, much as Italian law enforcement in the Mezzogiorno since the early 19th century has been thwarted by the Mafia, supported by a patron–client culture.

Similar examples abound. Most of the leading centers of power outside of Europe also had access to great wealth without much need to create sophisticated institutions to develop it. Beijing, Cairo, Constantinople, and Delhi all had command of extremely rich agricultural areas, and Constantinople was a trade center as well. Easy access to great wealth allowed the ruler to maintain rigid hierarchical control over the economy as well as the polity. In the short run each of these regimes could raise added revenues through increased taxation of its peasants. Increased repression to compel increased tax payments was a safer strategy for raising revenues than allowing more power into private hands. It was in the East that rulers were truly rich and their subjects miserably poor.

India is perhaps the most interesting case. It had 4 of the top 25 cities in 1500, 3 in 1600, and 3 again in 1700. In spite of continuous competition among a number of political entities, it failed to create any stable or progressive states and was taken over, a bite at a time, by the British East India Company. The Mughal emperors ruled over the great Gangetic plain, one of the richest agricultural areas in the world, and had incomes far larger than their European counterparts. Their main source of income was based upon taxing the farmers in the great plain. Like the Ottomans they never saw the need for the systematic modernization of institutions to increase their tax base, let alone the development of foreign trade. As alien Muslims in a Hindu land, they ruled through zamindars, who held land tenure for life, but could not pass it to descendants. Lacking property rights, the Mughal elites expressed themselves through conspicuous consumption, not systematic accumulation of wealth. The Mughals were never able to consolidate their power throughout the sub-continent; their empire was already decaying from within when challenged by the British early in the 18th century.

Beijing was also the capital of an empire, where the Manchus ruled from 1642 until 1912. The Manchus, like the Ming before them, saw China as the center of the world, without real rivals. In 1600 Beijing was almost three times the size of Paris, China had 6 of the world's largest 25 cities, and like India, it had a larger population than all of Europe. And with thirty thousand miles of canals linking its major populated areas, it had a far larger market as well. And yet, despite such fortunate circumstances and despite the fact that the Chinese pioneered in developing clocks, the printing press, gunpowder, and even iron, they did not have the external, competitive stimulus to promote economic development and thus did not develop a culture committed to continuous modernization. Indeed, their totalitarian state jealously guarded its powers, preventing potential entrepreneurs from ever having the freedom to create firms to mobilize capital and exercise significant economic power. While China, unlike India, did have nominal rights to private property, these rights were protected not by the state, but by local tradition and local elites. Beijing wanted total control; there could be markets but not even proto-capitalism.

The problems of these less successful countries were not initially technological or administrative. The Ming had the technological and administrative capabilities to send their fleets on exploratory voyages and reached Africa about a century before the Portuguese. But without the capitalist urge for profit, their expeditions were designed to give away tokens of their superiority in return for treaties recognizing their nominal sovereignty. In this case, the absence of the values stressed by Max Weber in his analysis of the rise of the west were surely of fundamental importance. Admiral Deng Ho commanded a Chinese fleet vastly larger and better equipped than any captained by Vasco de Gama or Columbus, but he failed to plunder, convert, or even profit from his voyages, leaving instead huge expenses to be paid in foreign exchange. Small wonder, then, that Beijing would order a halt to the voyages of exploration, the destruction of the navy, and a prohibition of maritime trade. A Chinese brand of capitalism would wait for the last quarter of the 20th century, or perhaps even the beginning of the 21st.

Japan is a prime and final example of the importance of governance to capitalist development. In the 1640s, Japan sealed itself off from external economic, technological and cultural influences for over 200 years. Like China, the goal of the Shogun's regime was internal control and not the rational use of resources to promote economic progress. Following the Meiji restoration in 1868, Japan would rapidly develop a state that could and would promote such development. The critical changes were, again, not in the discovery of new natural resources but in establishing governance and in opening the way for systematic importation of western ideas and technologies.

Conclusions

This book conceives of capitalism as a system of economic governance, requiring far more than markets to exist. As such, it identifies the emergence of capitalism with the emergence of not simply trading in ad hoc "natural" markets but rather trading in constructed markets entirely dependent on political, social, and economic institutions that are in turn shaped by political authorities, according to a purposeful political, social, or economic strategy. To both emerge and then thrive over time, capitalism requires, first and foremost, political action to effect societal and consequently economic change; specifically, it requires government to provide the requisite institutional and physical infrastructure to support a capitalist economy, to guarantee sufficient freedoms and protections to economic actors, and to respect the rule of law, accepting accountability for all of the above. Defining capitalism in this way has thus brought this chapter to conclude where and when capitalism emerged throughout history, as I will recap here.

Capitalism was created in Europe as part of a societal transformation where both markets and states replaced the previous feudal order. This transformation took place over about four centuries and was energized by a diverse set of events: a revival in trade, travel, and learning; a dramatic religious upheaval; almost continuous warfare; and a series of political takeovers. Favorable geography, improved law enforcement to facilitate trade, rising incomes to permit and support urbanization, improvements in an already favorable stock of technologies to enhance productivity, and good luck each played supporting roles.

The fact that no European country emerged to dominate all others during this transformation has long been recognized as pivotal in distinguishing European development from that of China, India, Latin America, or the Ottoman Empire. British foreign policy, with its concept of the balance of power, played a key role in protecting Europe from the rule of a tyrant, in effect acting almost as a multilateral form of governance for its era. This governance system had the effect of inhibiting political monopoly and thereby maintaining competitive pressures on Europe's various political entities. The effect was to maintain pressure on all political entities to innovate, and thus stimulate social, political, and economic change, in order to avoid hostile takeover.

Within this Eurocentric system, the real winners were the societies which innovated the most to create the social, political, and economic foundations for their emerging capitalist systems, i.e., the three-level systems described in the previous chapter. The willingness to grant increased power to private actors was one of the key innovations. It allowed for the release of energy, as Adam Smith so ably observed. However, this chapter has argued that the genius in the capitalist system was not in creating unregulated freedom for economic actors in markets, as is sometimes claimed, but in creating a system through which to regulate the exercise of these freedoms. Thus, local political authorities stopped trying to directly control so much of economic life via long-term contractual relationships for land or labor. Instead, they created an indirect form of control through various market frameworks that were regulated by rules, some of which were enforced by guilds and some by public officials and ultimately by courts. Moreover, they structured these rules and enforcement procedures to apply to the agents of the crown as well as to private parties. The successful transformation of the absolutist monarchies of the day required first that the various sovereigns and their agents refrain from preying upon their citizenry through outright plunder or the extortion of rents for little or no service in return; and second, that there exist a competent, equitable, and accessible system of justice. All of this depended ultimately on the creation of institutions to hold the sovereign accountable to some legitimate group of people such as a parliament. However, early forms of accountability fell far short of today's notions of democracy. Indeed, except in the United States, democracy would not be achieved until the 19th century, or after the period that Braudel and others have considered the formative years of capitalism.

To succeed, capitalist systems had to achieve the scale and scope to finance the military forces to ward off hostile takeovers and thus maintain a sense of stability within the system. At the same time, they had to achieve a culture that accepted the idea of the use of human reason to improve the human condition as well as a set of institutions that would facilitate the continuous improvement of technologies and institutions throughout society. A multitude of innovations were required, as suggested by the notion of an intermediate or proto-capitalist stage of organization. The creation of a strong state was essential for the mobilization of power for self-defense and the promotion of timely modernization of weapons as well as infrastructure. But control of such power made it imperative to find ways to hold governments accountable for how they used that power. In each case, it took regicide if not revolution to make this all-important transition to accountable governance. Even so, accountability was achieved only gradually, initially to an aristocracy and then, over a century or more, to a more broadly based electorate. Capitalism emerged side by side with the increasing effectiveness and effective accountability of government, not on the basis of immediate and unregulated freedoms and not hand-in-hand with democracy. Democracy would come later, an order that is of capital importance, as discussed in Chap. 3.

European capitalism did not emerge by a smooth or uniform process. Nor was it inevitable. Other societies, such as the Ottoman, Mughal, and Qing, with approximately equal incomes to Europe in the years prior to 1500, rejected capitalism for centuries as incompatible with their culture, institutions and structure of governance. Moreover, each of these societies was so powerful in the 15th–17th centuries that it was not under great competitive pressure to enhance its economic and military power and in this more indirect way, adopt capitalism by necessity. European societies had no such luxury; their societies were more acceptant of innumerable innovations because they were a way to gain the economic and ultimately the military strength that was essential to avoid takeover by a neighboring power.

Europe's societal transformation came in two phases. The first, proto-capitalist phase, was well underway before 1500 and was led by commercial cities and particularly by a handful of cities in northern Italy that were left more or less to govern themselves. These cities permitted their citizens' economic freedoms such as the rights to try new technologies and expand into new markets, as well as to buy and sell land. At the same time, these cities had the sophistication to recognize the need for an accepted set of rules of behavior to govern trade and indeed competition in their markets, including the need to protect the persons and property of those who risked their capital. With a legal system based on the rediscovery of Roman law as well as the creation of ingenious new institutions, the Italians were able to formalize their markets and create banking and insurance services as well as pioneer in double entry book-keeping and the development of a financial model of the activities of a firm. As a result, successful cities were able to increase the creditworthiness of their regimes and mobilize capital more effectively at the same time that their firms were themselves becoming more efficient. Public funds were used to improve physical infrastructure, hire civil servants, and finance armies while private funds supported the expansion of long distance trade.

Nonetheless, most of the early lead cities failed on one or both of two counts. With the notable exception of Venice, they failed to sustain accountable governments that would continue to modernize their economies as conditions changed. Tyranny and corruption would eventually destroy the legitimacy and the effectiveness of even the most innovative cities, and notably Florence. In addition, again with the exception of Venice, they would fail to achieve the scale necessary to finance military forces to forestall takeover by a powerful neighbor. Hostile takeovers would lead to a loss of freedoms, a drain of tax revenues in favor of a new administrative capital, and a loss in relative or even absolute size, most notably in Antwerp and Prague, but also in Genoa, Florence, and even Milan. Freedom to emigrate added to their decline, most especially in Antwerp.

The second phase, from about 1600 to 1800, was led by states that would gradually be transformed into so-called nation-states. Capitalism as we know it was created in England, France, and the United Provinces (and arguably Venice). The success of these societies was evident in the prosperity and growth of their cities, but was not based on their cities per se; rather, it was based on their success in adapting to a series of meta-innovations that permitted effective governance of a much larger territory. First, each would accept a considerable measure of religious toleration after the Thirty Years War (1648), thus separating the realms of church and state. This was essential if they were to break decisively with the status quo-oriented societal model fostered by the Catholic Church. It was only in this more liberal context that universities and other elements of civil society were free to play their full role as sources of new ideas and critics of various official institutions. Venice, though always a Catholic society, was perhaps the first of the successful nascent states to assert its independence from Rome when it came to picking its leaders, whether secular or ecclesiastical. Second, England, France, and the United Provinces were leaders in the Enlightenment, with its focus on the use of human reasoning to promote continuous improvement in the human condition. The demand for such improvement required more powerful as well as more effective and innovative government, and here again Venice would be a leader. Third, by creating the concept of a balance of power among states and maintaining it through shifting alliances, Europe and especially Britain created an external mechanism for promoting accountable government by subjecting incumbent management to near continuous competitive pressures of hostile takeover. At a minimum each state needed to search for more effective ways to run its economy, if only to be prepared, if it needed, to raise more taxes to hire troops for protection against hostile takeovers. The emergence of capitalism required institutional innovation that would disrupt the status quo and take power away from vested interests. Competitive pressures helped to justify the mobilization and application of such power.

Why did not any of the other great societies such as China, India, Japan, or the Ottoman Empire achieve some considerable measure of the capitalist transformation, thus potentially forestalling European colonialism? All were absolutist regimes with sovereignty over large populations. Repression was a route to higher revenues that was consistent with state power, at least for the short-term; economic freedoms were a threat to that power, but necessary to maintain that power over the longer term. With little pressure to promote innovation, they failed to create effective institutions to protect private property, let alone some of the key institutional innovations to use it more rationally, e.g., the joint stock company. Of the four only Japan would prove able to overthrow its regime and arrest the internal inertia and stagnation. Thanks in no small measure to the external challenge of Admiral Perry's black ships and the legitimacy of a largely symbolic Emperor, the Japanese feudal leaders were able to mobilize the power to overthrow their Shogun. The Chinese leadership failed when it attempted a similar coup about 40 years later.

For lack of a serious external challenge it was all but impossible for the three largest of these societies to mobilize the power to overthrow their regimes until they had degenerated too far to be saved. In terms of underlying social infrastructure, all three failed to separate church and state, and their legal systems remained largely rooted in tradition and oriented to protecting the status quo. In addition, all failed to experience and embrace the Enlightenment, with its advocacy of the use of reason and scientific method in the search for new ideas, new technologies, and improved laws and regulations. State control of wealth in their colonies supported a similar status quo orientation in the Portuguese and Spanish regimes, leading to the loss of their early positions of power and leadership.

The initially less favored European societies such as Britain, France, the Netherlands, and Venice left these societies behind as they sought to meet the challenges of creating a new and improved societal model to meet the pressures of continuous political and military competition within Europe and eventually around the world. And it was these same countries that led in creating a new, capitalist model in a milieu that was transformed by the Renaissance, the Reformation, and the Enlightenment, i.e., a context in which it became acceptable to use human reason to improve the human condition. But even with such intellectual change, drastic political change was still necessary to achieve a context in which capitalism could flourish. Without relentless competitive pressures and the takeovers of a number of weak political entities (e.g., a number of dukedoms to form France, and many more to form Germany), it seems doubtful that Europe could have accomplished such a radical transformation in its institutions of governance and its market frameworks in only a few centuries. Strong political accountability came very late in this transformation, a situation unlike that in the United States.

From a contemporary vantage point, Venice seems like the vanguard of this transformation. It was a city-empire governed by a duke who was accountable to a tiny oligarchy, not a democracy. The Dutch were perhaps second in order of achievement, with a weak confederation of states that were able to raise huge financial resources thanks to their organized trading system, on the one hand, and internally accountable state governments, on the other hand. England achieved a powerful state based upon the legitimacy of limited monarchy after 1689, roughly two centuries before the country had much by way of broad-based democracy. Finally, France achieved a powerful state based upon its large population and land mass, though governed by a dynastic model where the lack of internal accountability limited its ability to raise revenues, whether from taxes or borrowing. France was the foil for Adam Smith in the *Wealth of Nations*, i.e., a state where dirigiste government interfered in the economy to the detriment of national economic performance. It was also a state where, as Alexis de Tocqueville would point out, property was so unequally divided, even after the revolution of 1789, that democracy would risk the tyranny of the poor expropriating the rich.

This chapter has argued that the yeast that allowed Europe to rise, in Braudel's very suggestive metaphor, was to be found in the cities, but was not primarily due to urbanization itself. If cities had been the key, Europe's capital should have shifted to Constantinople/Istanbul and not to Amsterdam, Paris, or London. The key to the rise of Europe lay in creating a new sociopolitical system of governance that allowed new economic and then political freedoms, while at the same time regulating these economic freedoms to protect the public from the possibilities of private actors as well as state actors abusing their newfound powers. The cities were like the kitchens where the yeast could be observed doing its work, with incomes rising above those in the countryside. Thus, in my view, it was the release of human energy and intellect in a regulated context that created the rise of Europe, and not the cities themselves. Moreover, it was the entrepreneurial activities of governments in continually modernizing institutions (i.e., market frameworks) to promote and coordinate as well as regulate economic activities and thereby harness this human energy released by increased economic freedoms. This entrepreneurial role of government depended upon viewing laws and regulations as subject to experimentation and improvement, much like scientific experimentation, and on backing new ideas with political capital to achieve development. Societies that missed the Enlightenment were not similarly prepared for this process of institutional innovation. Institutional innovations, such as the joint stock company, facilitated the entrepreneurial activities of firms that would allow European societies to take greater advantage of new technologies and markets than societies with less flexible institutions, thereby allowing the Europeans to mobilize more energy more effectively than its erstwhile imperial rivals and thus pull far ahead.

Successful capitalist systems were never the free-for-all implied by the fundamentalist advocates of economic freedom; they were and still remain systems of regulated competition like organized sports. At various points in history and in various country contexts, the regulated release of human energy gradually developed into sociopolitical systems that could accommodate ever more complex concepts for the creation and transport of new wealth across distance and time. These systems developed in somewhat different ways, with more top-down control in France than in Britain, for instance, giving rise to varieties of capitalism, a contemporary notion that I will discuss at great length in Chap. 14. But no matter the variety, for any of these capitalist systems to work in ways that yielded results approaching the common interest, it was and still is necessary to constrain and then curtail the great inequalities in the distribution of wealth and income, i.e., move these capitalist societies closer to being governed democratically.

Australia, Canada, New Zealand, and the United States borrowed much from the European experience while benefiting enormously from the fact that they were not encumbered by the vested interests of the entrenched elites of a previous feudal system. It is to the Latin American experience that I turn next, and then to the contrasting experience of the United States.

Chapter 6
From Feudalism to Oligarchy in Latin America, 1500–1830

Europeans embarked upon the colonization of Latin America early in the 16th century, about 100 years before colonizing North America. Latin America seemed an auspicious choice at the time, in part because there were reports of gold and silver in the Caribbean and to the south, but also because the Caribbean and northeastern part of Brazil would prove to be promising areas for the cultivation of sugar cane. With this head start, estimated incomes in Latin America were generally higher than those in North America for the first 250 years of settlement, or until about 1750. Then, for the next 125 years, Latin America approached stagnation, while North America prospered and pulled ahead. Since about 1875, Latin America has experienced improved performance but has not achieved the convergence that economic theory would lead one to expect. What are the underlying causes of this poor economic performance over the last 250 years or so? Why has Latin America had such a hard time taking advantage of the increased opportunities in world markets, including in our own time?

While obviously there have been differences in performance among the various Latin American countries, only one—Chile—has at least arguably achieved a convergent pace of performance for the last 20 years. Chile's improved performance is widely credited to the introduction of market-oriented reforms conceived by the "Chicago Boys," a group of alumni who had studied economics at the University of Chicago. Less noticed by some is the fact that the reforms were not put into place by the markets or by a democratically elected legislature but by a military dictatorship under General Augusto Pinochet.[1] Two aspects of this Chilean experience are important to my analysis. First, the "market oriented" reforms were not achieved by or through the economic markets; they were effected through the political markets of a parliament that was under the control of a military dictatorship for almost two decades. Second, these reforms have added to the economic inequalities

[1] For an illustration of this naïve view see *The Commanding Heights*, either in the original text by Daniel Yergin and Joseph Stanislaw, or the WGBH documentary complete with interviews with key participants: Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace that it Remaking the Modern World* (New York: Simon & Schuster, 1998); William Cran and Greg Barker, "Commanding Heights: The Battle for the World Economy" (WGBH Boston, 2002).

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_6,

of an already inegalitarian society, leaving a society that is still a distorted oligarchy, where the nature of this oligarchy has again surfaced as a political issue. Thus, while some cite Chile as an example of what markets can do, I would argue that it is a model of what a dictatorship can do to impose market reforms through an illegitimate political process, thanks to the backing of an army. Surely this process of reform is not an appropriate model for democratic societies to follow. Furthermore, unless the issue of oligarchy is successfully addressed the results may not be a model either; Chile may become another polarized and sub-par performing Latin American country once again.

Why is it that Latin American nations are unable to achieve so-called market-oriented reforms through democratic processes? In this chapter, I will suggest that the causes of Latin America's weak performance since 1750 stem from the distorted and repressive institutions inherited from the colonial period. Further, I will argue that these distortions are largely located in its factor markets and exacerbated by inadequate provision of public goods, both of which can be traced in large measure to the strategy that accounted for Latin America's strong relative performance over its first 250 years of European settlement and to the colonial political institutions through which this strategy was implemented. To this end, I interrogate historical data and scholarly explanations, evaluating the roles played by capitalism, political governance, and inequality in limiting Latin America's economic growth.

My approach contrasts sharply with the writings of Hernando de Soto. In the opening chapter of his much-admired book *The Mystery of Capital*, de Soto diagnoses an inability to produce and mobilize capital as the cause of stagnation throughout much of the developing world, including Latin America. De Soto's analysis builds from his assumption that capitalism has been present since pre-Columbian times and is ubiquitous in developing countries, as demonstrated by the existence of markets and entrepreneurs, the familiar indicators of capitalism. He asks: "What is it that prevents capitalism from delivering to [the people in developing countries] the same wealth it has delivered to the West? Why does capitalism thrive only in the West, as if enclosed in a bell jar?"[2] He finds his answer in the defective form in which assets are held by the poor in developing countries.

De Soto, like Friedman, thinks of markets as being achieved through evolutionary processes, such as by market forces, and naturally looks for the gradual improvement in the availability of titles, deeds, registries, and so on. However, if one thinks of the establishment and modernization of markets as an administrative and ultimately a political process, involving a shift in power away from certain groups toward others, as, for example, during the Pinochet regime, then it is essential to recognize that human agency is required to enact the necessary reforms. This parallels the argument of Richard Lachmann in his analysis of the European experience

[2] de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, 5. De Soto seems to have overlooked the fact that capitalism appears to be alive and thriving throughout East Asia, where real incomes adjusted for purchasing power have come from levels much lower than those in Latin America to pass them and also to converge toward those in the West.

over roughly this same time period, as we saw in the previous chapter. In this second perspective, reform is the result of political reform rather than market-based activities, and change can be expected to be disjunctive rather than smooth, as when a regime is voted out of office or, at the extreme, overthrown by a brutal dictator. Does either of these narratives further our understanding of the causes of underdevelopment in Latin America? Let us consider de Soto's thesis first, and then survey what is known about the institutional development in Latin America over its formative years from 1500 to 1750.

Hernando de Soto on Underdevelopment

In *The Mystery of Capital*, de Soto identifies the lack of credit (capital) as a fundamental problem for developing countries and argues that a solution to this situation lies under the countries' own control if they would assess and fix the shortcomings in their own economic systems. Working with a team of associates de Soto developed data to illustrate the availability of domestic capital sources in four countries—Haiti, Peru, the Philippines, and Egypt. In each of these countries he and his team found very substantial quantities of "dead capital," property that could not be used as collateral to obtain loans. The manifest reason for this dead capital is that owners do not have clearly established ownership of their property. In his analysis, these developing countries have markets and entrepreneurs and thus capitalism, but they suffer from a lack of capital. De Soto estimates of the dollar values of this "dead capital" to be much larger than all recorded foreign investments that the four countries had received in their recorded history, as indicated in Table 6.1.[3]

De Soto argues that because these four countries have significant differences in history and culture, they represent valuable and suggestive evidence, albeit evidence based on a small sample. He sees the lack of appropriate means with which to represent their property as a key indicator of their problems

Table 6.1 Estimated "dead capital" relative to foreign investment

	Dead capital in billions	As a multiple of all recorded foreign direct investment
Haiti	\$5.2	158×
Peru	\$174	14×
The Philippines	\$133	14×
Egypt	\$240	55×

Source: Adapted from Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), 27–28

[3] de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*.

> The poor inhabitants of these nations—the overwhelming majority—do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adapted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work. This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them.[4]

In the last chapter, we saw that the key problems in the establishment of European capitalism lay in the factor markets, and notably in the underdeveloped or nonexistent markets for land, for labor, for the authorization of new firms, and for the mobilization of finance capital. De Soto suggests similar roadblocks for all developing countries, particularly Latin America. How does his argument compare with that advanced in this book? While both arguments seem to focus on capital markets, de Soto's highlights the lack of instruments to represent ownership—the titles, deeds, and mortgages—and the problems that he identifies are technical and procedural, as in inadequate filing and data processing systems for their registration and recognition. In contrast, the previous chapter focused on these same issues in terms of who had the power to shape the factor markets, for example, privatizing land through forced expulsion of peasants from usage rights to common land, or at the other extreme, terminating payments in labor or in kind in favor of payments in cash. According to this second line of analysis, capitalism was not established as the dominant system of economic governance in Europe until the previous feudal system was effectively overthrown in the factor markets, with the state offering its protection to the owners of the factors of production. In the British case many peasants were dispossessed by acts of Parliament, and the new owners were protected by the state, all in a context where the dispossessed had no means of redress. In a process that sounds almost "Latin American," the poor own some of the property but, ironically, are nevertheless unable to mobilize its value because they are unable to achieve its formal recognition, e.g., through titles and deeds.

Reviewer Christopher Woodruff has elaborated on de Soto's argument to point out that the inability to achieve formal recognition of their property is a handicap for the individual as well as for society. While the owner might still find a lender, the lender must know the borrower, and thus the size of the potential market for mortgage capital is greatly reduced and the cost of credit correspondingly increased, which is consistent with the bank data in Table 6.1. Woodruff continues

> The inability to use assets as collateral . . . means that transactions must be limited to smaller communities of traders. Potentially profitable trading opportunities must be passed up; the extent of division of labor is limited. Once a property system is established, people are freed to choose from among a larger set of trading partners. Trade between strangers is

[4] Ibid., 6–7.

> possible because with a functioning property system, there are no strangers. Everyone's economic worth is relatively easy to ascertain.[5]

Clearly de Soto has made an important observation, and indeed his work has received prominent notice around the world. Unfortunately, he has not provided documentation of his analyses, either of how he values the undocumented property, or indeed how he knows that it is undocumented, so his results are not easy to duplicate. But the exact amounts are not as important as the idea, and surely it is a remarkable insight. What is the problem: is it primarily in achieving recognition of ownership?

A piece of paper that establishes title is not equivalent to the ability to establish ownership, let alone convert an asset into capital. For the latter, the asset must be accepted as valid collateral for a loan, which means that it must be technically valid and also registered in the proper government office to be recognized as legal. With that registration, one can apply for a mortgage, and it is this step that leads to successful mobilization of the financial potential of the tangible assets. But even this step is not enough: A bank may not wish to give such a mortgage unless the title is insured, and it is unlikely to grant the mortgage unless it believes the latter to be enforceable in court. Here one encounters a number of potential problems that go far beyond the question of the legality of the title. In some Latin American countries, including in Brazil through its recent constitution, as in some US states, a homestead may not be attached in order to collect for a debt, whether there is a mortgage or not. Thus, this very route to the creation of capital based upon a primary residence has been barred by law, as a way to protect prospective debtors from themselves. Since many if not most of the houses de Soto surveyed are likely to be first homes of poor people, there may be little potential to mobilize capital, whatever the status of formal ownership.

And there is a further problem that can be very real in poor communities—that of the legitimacy of the transfer of title. What if the court permits foreclosure and awards the property to the creditor, but the local community will not allow the creditor to take possession? What if the neighbors threaten bodily harm to the prospective new occupant or the property, because the legal process is judged illegitimate? Since poor communities can be expected to be suspicious of the formal authorities, and in many cases have informal political organizations of their own, as in some of the favelas in Brazil or similar gangs in Venezuela, formal recognition of ownership by the banks and the courts may be a sign of illegitimacy instead of the reverse.

At each stage in this process of financial mobilization of dead capital there are political as well as technical realities to be considered. If the registrar refuses to accept the deed, it may not be registered; if the court refuses to recognize the mortgage, it is not valid; if it takes 10 years to get on the docket for a hearing in court, its validity is uncertain and of little present value; and if the local police either will not protect the creditor in the event of attempted foreclosure and seizure of the

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[5] Christopher Woodruff, Review of *The Mystery of Capital*, by Hernando de Soto, *Journal of Economic Literature* 39, no. 4 (December 2001): 1216.

property, or will not protect the new occupant, the whole process comes to naught. The mobilization of the implicit value of these tangible assets is ultimately a test of the strength of its capitalist institutions and, to reiterate, these institutions constitute a system of political economy and not just one of markets.

What, then, is the experience with the titling of land? *The Economist* proposes

> Recent studies in Argentina and Peru have found that title indeed encourages the poor to invest in improving their houses. They also spend longer working outside the house, because they need to devote less time to seeing off intruders, and they are less likely to put their children to work. For all these reasons, property titles matter. But, the studies found, poor people with title are no more likely to obtain a loan from a commercial bank.[6]

Despite the 20 years of experimentation with titling since de Soto first addressed the issue of dead capital, with his publication of *The Other Path*, no strong evidence indicates that it has produced increased financial mobilization anywhere. The mobilization of currently dead capital is not just or even primarily a technical issue. It is indicative of a set of institutional problems, encompassing the costs of settling disputed claims, the delay in securing a hearing in court, and the uncertainties involved in successfully passing the property on to a new owner, which is ultimately what the lender must do to recover his capital in the event of default. Ultimately, these issues are political and not technical. As Woodruff contends: “Formal titles increase access to formal credit. Capital markets function poorly in developing countries for reasons other than property title. Unlocking capital will require more than just recognizing existing informal property rights. At a minimum, a set of complementary reforms—for example, of bankruptcy laws and banking regulations—will be required.”[7]

De Soto cites US experience in the settlement of informal claims through informal means, on location, for example, in the west. In the US West, the illegal seizure of land was often recognized; but why? Woodruff explains: “Because squatters represented votes, often the majority of votes in new states. Development of a formal property system was driven primarily by political, not economic actors.”[8]

Woodruff points out an important irony in de Soto’s argument: If the key to establishing title for the poor is to recognize informal or squatter holdings, this in fact recognizes property rights for individuals who have taken title through invading the property of the previous owner. Can a new system of secure titling be built upward from a foundation based upon illegal seizure? Why should not the next generation of squatters continue the process? He asks: “Would an amnesty for those who have previously benefited from the invasion of other’s land lead to greater respect for property? Would it instead increase the motivation for invasion?”[9]

I would also raise a question concerning de Soto’s analysis from a different vantage point, that of the legitimacy of the pattern of land ownership. As the next

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[6] “Of Property and Poverty,” *The Economist*, August 26, 2006.

[7] Woodruff, Review of *The Mystery of Capital*, by Hernando de Soto, 1220.

[8] Ibid., 1218.

[9] Ibid.

chapter details, US development of land ownership followed the New England model of small plots, which assured overwhelming participation in land ownership among the population. This notion of small holdings to achieve widespread ownership became the basis for the Northwest Ordinance, which mandated a government-financed survey of the 400,000 square miles of trans-Appalachian lands, with sales only for cash, to limit the role of speculators or developers. Furthermore, all of the land was to be surveyed before formal settlement got underway, so land owners could cite boundary marker established by US government agents as references for their titles, a degree of certainty unmatched in most countries, and utterly the opposite of the claim situation in California, the American example that he references. This pattern of formally sanctioned titles would be repeated with the Homestead Act, which carried these same ideas to the Rocky Mountains. Americans have had respect for land ownership not so much because they had squatters' rights as because most of them had their rights to title based upon governmental surveys. Furthermore, the patterns of land ownership were rather different. Whereas 74.5% of Americans and 87.1% of Canadians held land in 1900/1901, the comparable figure was only 2.4% in Mexico (in 1910) and 19.2% in Argentina (in 1895).[10] The ownership of land was a defining characteristic of early US experience, while the absence of such ownership was the norm in Latin America.

De Soto focuses his analysis on markets and economic actors and all but omits the legitimacy of property ownership or its protection through the police powers of the state, and hence all but overlooks the system of economic governance. He observes the ubiquity of entrepreneurs, and proceeds on the assumption that the same is true for capitalism. However, capitalism is a three-level system where government must successfully mobilize power to establish, legitimate, and administer the rules and regulations of a market framework, and likewise have a monopoly of coercive force to settle disputes should they arise. De Soto focuses only on the first level of the system illustrated in Fig. 6.1, overlooking the necessity if not the very existence of the other two, i.e., capitalist institutions and governing authorities. Thus, the problem that de Soto initially describes as assets without proper documentation that cannot be mobilized as capital, i.e., a problem of not having a market (level one), is more accurately understood as the problem of having societies with underdeveloped capitalist systems, i.e., a problem of lacking proper regulatory frameworks and adequate legal protections for those who would make transactions in their capital markets (levels one, two, and three). Furthermore, it is a problem not just of underdeveloped capitalist systems but *illegitimate*, in a sociopolitical sense, capitalist systems; in many cases the ownership of property is so skewed in favor of the rich as to lack legitimacy in the eyes of much of the population.

From my perspective, the Latin American countries suffer for a lack of capitalism, rather than for the lack of capital that de Soto highlights. It is precisely their

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[10]Stanley L. Engerman and Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, NBER Working Paper (Cambridge: National Bureau of Economic Research, 2002), 49, Table 6.

Level 3: Political Authority

Legislature

Level 2: Regulatory Authorities & other Institutions

Courts | Bank Regulators | Registry of Deeds

Level 1: Capital Markets

Suppliers of Capital	*Instruments Mortgages Deeds Insurance*	*Users of Capital*

Fig. 6.1 De Soto's model of capitalism (italicized above) is limited to the first level of capitalism. Source: Bruce R. Scott

poorly developed capitalist systems that make it hard for many developing countries to mobilize capital, foreign or domestic. Local private sector entrepreneurs are indeed handicapped by ill-documented assets, but they are still more handicapped because their governments have failed in their responsibilities to modernize the institutions of their capitalist systems, and not least their law enforcement systems. And, lest it be overlooked, local vested interests, and notably but not exclusively business interests, have played a crucial role in blocking such reforms and thus prolonging underdevelopment.

For the poor to have title is surely a good thing, but for them to be able stand up to powerful people who have extrajudicial power to harm them on behalf of wealthy oligarchs or an informal government in a slum neighborhood, assumes either adequate police presence to protect them, or a rival illegal vigilante organization to do so. The latter represents another form of non-judicial power. The scarcity of police power to protect the poor is an important symptom of an incomplete state in many of the Latin American countries. De Soto, like other Free Market fundamentalists, overlooks the essential nature of government in providing and enforcing market frameworks, which are particularly important in making opportunities available to people of modest means or limited education.

As Woodruff writes

> De Soto's own experience in Peru suggests that land titling by itself is not likely to have much effect. Titling must be followed by a series of politically challenging steps. Improving the efficiency of judicial systems, re-writing bankruptcy codes, restructuring financial market regulations and similar reforms will involve much more difficult choices for policy makers. These are swept under the rug in the text of *The Mystery of Capital*. Land titling is made to sound like a free lunch. . . . There is almost certainly something to what de Soto says . . . the question is, How much?[11]

[11] Woodruff, Review of *The Mystery of Capital*, by Hernando de Soto, 1222–1223.

These few pages do not presume to answer Woodruff's question of "How much?" What they can do is to suggest that a large part of the answer is rooted in Latin America's much delayed and deformed versions of capitalism. One of the salient indicators of that deformed capitalism is the extreme inequalities of income, wealth, and power that characterize Latin America. These inequalities rob Latin American regimes of the legitimacy that can only be earned, when a regime is generally perceived to be at least somewhat fair in its distribution of wealth and power and in the protection that it provides for its citizens. Latin America is an extreme case of a shortage of legitimacy, and the problem is one of very long standing. A 2004 World Bank report indicated

> For as long as data on living standards have been available, Latin America has been one of the regions of the world with the greatest inequality. With the possible exception of Sub-Saharan Africa, this is true with regard to almost every conceivable indicator, from income and consumption expenditures to measures of political influence and voice, and including most aspects of health and education.[12]

The extreme inequality that characterizes many Latin American societies is symptomatic of distorted, malfunctioning factor markets where much of the population has little or no property and lacks the education necessary for finding opportunities in a modern economy. A fully functioning capitalism requires not minimal government but good government, government which provides the public goods for which it is responsible, including physical and social infrastructure, effective law enforcement, and education. Such good governance proceeds through legitimate political processes that have some plausible claim to meet Abraham Lincoln's test of being *for* the people as well as *by* the people. Ample documentation shows how and why Latin America, which arguably had a head start in it product markets relative to North America, developed such distorted factor markets and inadequate public goods. The remainder of this chapter reviews that research in order to suggest the extent to which these distortions account for the problems that de Soto has encountered, and also why these institutions became so entrenched.

From Factor Endowments to Factor Markets

Traditional explanations of Latin America's poor relative performance since 1750 have emphasized weaknesses attributable to its Hispanic heritage, including the establishment of exploitative colonial regimes run for the benefit of the mother country and a small elite of expatriate Europeans. They would also lead us to inquire about Latin American achievement of independence, and how its governance might have changed following independence. However, recent research by Stanley Engerman and Kenneth Sokoloff has supplemented and to a degree challenged this traditional explanation of Latin America's relative decline by emphasizing the role

[12] David de Ferranti et al., eds., *Inequality in Latin America and the Caribbean: Breaking with History?* (Washington, DC: The World Bank, 2004), 17.

of initial factor endowments as a powerful influence on the development of institutions in the post-Columbian period. Specifically, Engerman and Sokoloff point out that areas characterized by rich factor endowments were developed through exploitative institutional systems wherever they occurred, regardless of the nationality or culture of the explorers and early settlers who colonized them. This line of analysis helps illuminate how and why British settlers in Barbados, Jamaica, and indeed the US South would initially establish institutions that were much like those in Hispanic areas.

In light of the analysis in the previous chapter, the Engerman and Sokoloff argument also raises the question of when the various Latin American countries are properly understood as having achieved capitalist systems. Was most or perhaps all of Latin America in the 16th and 17th centuries even more repressive than Europe under feudalism, and therefore, in Braudel's terms, not capitalist in spite of its participation in world trade? Assuming that the Aztecs and Incas and perhaps the Mayans before them traded in product markets, did they have active markets for land and labor, as well? Did the conquerors of Latin America retain or establish such markets? Were British or Dutch or French colonists more likely to do so than their Hispanic predecessors or contemporaries? If not, and if Latin America experienced little or no development of its factor markets in the early years, at what point can we say that Latin American countries became capitalist? To raise these questions is to suggest that Latin Americans may have had a good deal less experience with capitalism than is sometimes supposed.

Why should we question the existence of factor markets in Latin America, and why again should we suggest that their establishment might require the overthrow of the status quo as it had in Europe? Engerman and Sokoloff's observations provide the basis for a hypothesis on the much delayed development of factor markets in Latin America and the possibility that such market developments might require political conflict and thus be disjunctive. Their observations center on extreme economic inequalities, maintained over long periods of time; as they write

> [I]n societies that began with extreme inequality, the elites were both inclined and able to establish a basic legal framework that ensured them a disproportionate share of political power and to use that influence to establish rules, laws, and other government policies that gave them greater access to economic opportunities than the rest of the population, thereby contributing to the persistence of the high degree of inequality.[13]

Since the laws and policies that they refer to are in reality among the institutional foundations of the respective socioeconomic systems, we can reconfigure their argument to the effect that European settlement of Latin America started the latter societies off with a set of institutions favoring a small group of elites. These institutions systematically gave privileged access to land to elites, who were also granted better access to public goods such as education and infrastructure, and the opportunities for upward mobility were correspondingly restricted for a large

[13]Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 17–18.

fraction of society. These institutions were implemented and maintained through concentrated economic power backed by repressive political regimes. Whereas the Europeans who remained in the "old countries" would eventually overthrow their feudal models in favor of governance regimes that professed to provide justice to their citizens in return for loyalty and the payment of taxes as they developed their capitalist systems between 1500 and 1800, the European entrepreneurs who conquered and colonized Latin America created and administered societies based upon overt oppression of the native population and slaves imported from Africa. They added slavery or forced labor to feudalism, and maintained their systems through centralized decision-making, in stark contrast to the decentralization of economic decision-making, which released the energies of Europeans in their emerging capitalist systems.

My account of the early developmental history of Latin America draws heavily on Engerman and Sokoloff's work concerning the origins of the inequalities that came to characterize Latin America, their linkages to distorted institutions, and the roots of these institutions in very unequal distribution of political power within these colonies. Essentially, I will condense their findings, and argue that the structures of governance in place in Latin America enabled the characteristic economic strategy of export promotion based upon forced labor. This early history suggests how institutional innovations could stunt the development of the physical and social infrastructure of Latin America and, perhaps worst of all, stunt the development of its human resources. I branch off from Engerman and Sokoloff to devote some attention to Jamaica, the only large British colony in South America, to show that it too followed the developmental trajectory suggested by its factor endowments despite its British settlement and governance. In addition, I go beyond the path dependency argument to point out that extremely unfavorable circumstances in Spain played a particularly unfortunate role in the governance of the Spanish colonies throughout the first 250 years of settlement. Not all of the damage was done in the early years; it was reinforced by continuing misgovernment by a bankrupt regime in Madrid. Having laid the groundwork of historical analysis, I briefly examine more recent data, which suggest that the persistence of maladapted capitalist institutions continues to retard the development of Latin America. Despite the recent acclaim awarded Hernando de Soto's analysis, Latin America's continuing problems are best understood as a shortage of capitalism and not, as de Soto suggests, as a shortage of capital.

The Founding Years

When the Western Hemisphere was "discovered" by Spanish and Portuguese explorers, they had their choice of where to settle, from Newfoundland to Patagonia so to speak. This might have seemed like a remarkable range of opportunities, but only because the early colonists expected to have powers no longer available to immigrants. In fact, one might have wondered that they risked the sea voyage, possible

Table 6.2 Relative GDP per capita in European colonial powers and former colonies (1990 international dollars)

	1500	1700	1820
Britain	762	1,405	2,121
France	727	986	1,230
Italy	1,100	1,100	1,117
Netherlands	754	2,110	1,821
Portugal	632	854	963
Spain	698	900	1,063
China	600	600	600
India	550	550	533
Brazil	400	560	646
Mexico	425	568	759
United States	400	527	1,257

Source: OECD (2001), The World Economy: A Millennial Perspective, p. 90, www.theworldeconomy.org

diseases, and unknown hazards in the New World, when incomes in Portugal and Spain are now estimated to have been at least 50% higher than those in Brazil, Mexico, or the United States between 1500 and 1700, as shown in Table 6.2. The European colonizers, however, did not arrive in the New World with the idea of working their way up from the bottom. If they had, Italy would have been a better target, as its average incomes were more than 50% higher than those of Portugal and Spain, and by 1700 the really high income area was the Netherlands, with incomes more than double Portugal's or Spain's or indeed those of any other country other than Britain and Italy.[14]

The early areas of preferred settlement were overwhelmingly in the tropics, i.e., the Caribbean and present-day Mexico, Peru, and the northeast of Brazil. Latin America was not richer, on average, than North America, but early entrepreneurs were looking for opportunities and not for averages. These opportunities included the potential to discover precious metals in the Caribbean region or silver or gold further inland in Mexico and Peru, and to grow valuable crops in sunny climates with plenty of rainfall and access to ocean transport to Europe, and to enslave the local Amerindian population. Thus, the attractions in South and Central America, Mexico, and the Caribbean lay not in average incomes, but in the possibilities for extractive strategies in targeted areas to be worked by forced labor and/or slavery for the benefit of the conquerors. North America, north of the Chesapeake, had fewer targets of rich opportunity, in part because there were no significant reserves of gold and silver, fewer opportunities to raise high-value crops, and far fewer Amerindians to be pressed into forced labor.

For the first 150 years of settlement, approximately 80% of European migrants were of Portuguese or Spanish origin. They were looking for a chance to get rich.

[14] Maddison, *The World Economy: A Millennial Perspective*, 90, Table 2-22a.

While the Spanish initially focused on precious metals, the Portuguese were also interested in opportunities to make money through agriculture. In both cases the settlers went overwhelmingly to the tropical areas, in spite of the health risks involved.[15] And in both cases the early settlers lost little time in discovering that it was preferable to have someone else do the work, Amerindians if possible, but African slaves if need be.

The British were about a century later in starting, but from 1650 until 1760 almost half of the European settlers in the New World were British. This led to a very different pattern of settlement; for the years 1630–1780, an estimated 35% of those British settlers went to the tropics (the West Indies) while 45% went to the US South. The Middle Atlantic States and New England, with climates that were less prone to tropical diseases, attracted only 20% of the immigrants, most of whom settled in the Middle Atlantic.[16] While the British colonists arrived later and settled farther north than the Spanish and Portuguese, most of the European colonies were set up to make use of forced labor if that could be done economically. The settlers' nationality mattered less than their new surroundings. Up through 1780 about 80% of British settlers to North America resided in British colonies characterized by slavery, with 35% of settlers in the West Indies, 44% in the US South, and only 20% in the Middle Atlantic and New England combined.[17] At the same time, the West Indies attracted 83% of the slaves shipped to the British colonies, while the southern islands in the Caribbean received almost 17%, virtually all of the remainder.

The earliest settlements in the Western Hemisphere enjoyed at least a century in which to develop their plantations, export to Europe to finance tools and luxuries, and build a civilization before the less favored regions had any significant settlements.[18] Arguably, the colonies that attracted the most settlers and slaves were also the ones with the highest exports, as suggested by British trade data in Table 6.3. For example, the British West Indies exported far more to Britain than all of North America at least through 1820. Indeed historical research has estimated that the richest areas in the Western Hemisphere were in the tropics until about 1700–1750, as suggested in Table 6.5. However, the accumulated advantages are not very impressive, with Mexico maintaining a small lead with respect to the United States by one source and a small lag by another (see Tables 6.4 and 6.5). Surely part of the reason for this unimpressive build up of advantage is that both Portugal and Spain saw their colonies as offshore enclaves to be exploited for the advantage of the mother country. Thus, trade was controlled, and production and/or exports were taxed without regard for the welfare of the new societies—European, mixed descent, or Amerindian.

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[15] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, Table 1.

[16] Ibid., Table 2.

[17] Ibid.

[18] Ibid.

Table 6.3 Structure of British commodity trade by origin, imports, 1710–1996 (percent of total current value)

	Europe	Asia	Africa	North America	British West Indies	Other America	Australia and New Zealand
1710	63.6	6.9	0.4	7.3	21.7	0.1	0.0
1774	46.1	11.4	0.4	12.5	29.3	0.3	0.0
1820	26.8	24.6	0.5	14.6	26.0	7.5	0.0
1913	40.7	15.7	3.0	22.6	0.8	9.6	7.6
1950	27.8	17.2	11.0	15.9	5.1	8.6	14.4
1996	61.7	18.8	2.2	14.1	0.3	1.7	1.2

Source: OECD (2001), The World Economy: A Millennial Perspective, p. 93, www.theworldeconomy.org

Table 6.4 Relative GDP in the Western Hemisphere, 1500–1998

	1500	1600	1700	1820	1870	1913	1950	1973	1998
USA	100	100	100	100	100	100	100	100	100
Mexico	106	113	110	60	30	32	24	31	25
Latin America	104	109	100.4	52.9	28.5	28.5	24		21.2

Source: OECD (2001), The World Economy: A Millennial Perspective, p. 264, www.theworldeconomy.org

Table 6.5 GDP per capita in Latin America relative to the United States

	1700	1800	1900	1950[a]	1997
Argentina	–	102	52	52	35
Barbados	150	–	–	–	51
Brazil	–	50	10	17	22
Chile	–	46	38	40	42
Cuba	167	112	–	35	8[a]
Mexico	89/108[a]	50	35	25	22
Peru	–	41	20	24	15

[a]Adapted from OECD (2001), The World Economy: A Millennial Perspective, p. 288, www.theworldeconomy.org

Source: Adapted from Stanley L. Engerman and Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, NBER Working Paper No. 9259 (Cambridge, MA: National Bureau of Economic Research, 2002)

But from 1750 until almost 1900 the Latin American countries stagnated, and areas of the New World that had been unclaimed and/or laggard for the first 250 years passed them up and opened up a substantial lead in incomes and other indicators of well-being, not to mention economic power. Why would the early leaders stagnate, when they had first choice in terms of where to settle, chose areas where they could locate or create remarkable comparative advantages through which to participate successfully in world commerce, and, at least in theory, had great opportunities to build capital stock relative to the later arrivals? Why would they fall behind, and keep on falling further behind for the next 250 years, with a brief interlude of apparent convergence in the 1960s and 1970s?

Traditional explanations of the development of the Western Hemisphere emphasized institutional disadvantages emanating from the Iberian Peninsula. Spain and Portugal both permitted slavery and were more dominated by their rural elites than Britain, as their rural nobility allied itself with the Catholic Church to restrict urbanization and industrialization and to keep agricultural wages low so as to help the rural aristocracies enjoy their less productive lifestyles, as we noted in Chap. 5. While there is certainly some merit in this traditional account of institutional differences, inconsistencies exist, as well. British settlements in the Caribbean, for example, in Barbados and Jamaica, also adopted slavery, as indeed did the British settlements in the southern US. Thanks to the employment of forced labor, Britons in the Caribbean were soon far richer than their countrymen in the United States or England. But then the British areas in the Caribbean fell behind their northern counterparts, like the other early colonies. Recent scholarship provides a compelling analysis that focuses on relative factor endowments as a key variable to explain which areas were settled first, what markets they would aim to produce for, what productive systems they would adopt, and the institutions that they would create to allow their productive systems to function efficiently.

Engerman and Sokoloff argue that the original colonies were chosen for their richer factor endowments, whether their suitability for export crops such as sugar, tobacco, and eventually cotton, their gold and silver mines (as in Mexico and Peru), or their denser native populations. They also argue that these original factor endowments were at the root of the later troubles of the original colonies. The connecting link is that the original colonies all enjoyed the possibility for the early European settlers to get rich on the backs of forced labor, whether slaves from Africa or hardy Amerindians that would survive the combination of new diseases and sometimes murderous work regimes brought by the settlers. Engerman and Sokoloff formally classified the colonies into three types, based on their factor endowments, production systems, and institutions and forms of governance. In reality, however, they identified five categories of colonies, and I will use this larger number, much as they have, as shown in Table 6.6.

Group I: Barbados, Brazil, Cuba, Haiti, Jamaica

The first type of colony, as already suggested, was based upon the establishment of plantation agriculture, especially not only sugar, but also tobacco and later cotton, and the use of forced labor to tend these large holdings. Plantations were either started on very large initial land grants or on much smaller plots that were consolidated to gain economies of scale. These colonies rapidly came to be characterized by slave labor of African descent, with Africans demographically dominant in the population. Slaves and other forced labor were all but absent in the power structures of their respective societies. These early colonies in Group I included Barbados, Brazil, Cuba, Saint Domingue (present-day Haiti and the Dominican Republic), and Jamaica.

Table 6.6 Factor endowments, inequality, and paths of development among new world economics, 1500–1750

	Group I	Group II	Group III	Group IV	Group V
Location	Caribbean N.E. Brazil	Mexico Peru	US South	Argentina	US North
Nationality	British French Dutch Spanish Portuguese	Spanish	British	Spanish	British
Factor endowments	(+) Rich land (+) Climate (+) Water transport (–) Disease	(+) Amerindians (+) Gold, silver	(+) Rich land Or (−) Mediocre land (−) Disease	(+) Abundant land	(+) Abundant, variable land
Immigration	60–90% Slaves	Restricted (50% slaves)	Encouraged (40% slaves)	Restricted	Encouraged (3% slaves)
Production system	Plantation agriculture with slaves	Mining with forced labor Encomiendas	Plantations with slaves Or Family farms	Large ranches Grain Beef	Family farms
Key markets	Europe	Europe Local	Europe Or Local	Europe	Local
Distribution of income/wealth	Very unequal	Very unequal	Very unequal Or Middle class	Very unequal	Relatively equal
Policy tilt of institutions	Centralized Elitist	Centralized Elitist	Decentralized Elitist Or Mixed	Initially ruled from Peru Centralized Elitist	Decentralized Egalitarian
Provision of public goods	Very limited	Minimal	Variable	Mediocre	Very good
Public access to opportunity	Very limited Poor	Very limited	Variable for whites	Mixed	Very high
Growth to 1750	> United States	Ok	<Northern US	Good	Ok
Growth after 1750	Very poor	Very poor	<Northern US until 1940s	Good growth to 1900	Superior

Source: Adapted from Stanley L. Engerman and Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, NBER Working Paper No. 9259 (Cambridge, MA: National Bureau of Economic Research, 2002), with author's expansions

Latin American societies established with institutions that permitted slavery developed social structures even more repressive than those in Europe at that time. Thus, most of the population was not allowed to share the powers of personal choice that constitute a key pillar of capitalism. Slaves were less free than serfs, who, while tied to the feudal estates and obligated to perform a variety of non-market obligations to their landlords, nevertheless, had some control over their time, what they produced, and their family affairs, e.g., their family members were not for sale. Amerindians subjected to the encomienda system, too, enjoyed freedoms unavailable to slave laborers. The slave-based systems stripped laborers of any control over their own family structures let alone the disposition of their time. These systems were productive and employed capital, but the bulk of their inhabitants were not permitted to be part of their capitalist enclaves. Roughly 10–30% of their inhabitants were in their capitalist systems. Most of the inhabitants had little or no opportunity to sell their labor on the market or to own land or attain an education, or even to plan and raise a family that might inherit some resources accumulated by their parents. They might have the right to farm a small garden, and perhaps to sell a small surplus, but they were anything but capitalists.

The elitist focus of the Latin American systems was manifested in the underdevelopment of public goods. As export-based economies, they tended to selectively build roads and make other improvements to move crops from plantations to seaports, while little effort was made to develop a meager home market or even a town by building the roads that might be desirable for such projects.[19] As the rich could afford private schools, and even to send their children to schools and universities in the mother country, little effort was made to develop public education. Brazil was run as a "milch cow" for Portugal for about 300 years, with strict limitations on the importation of printing presses, the development of manufactures that might compete with those in Portugal, or the development of universities.[20] This would begin to change when Napoleon's armies overran Portugal and the court fled to Rio de Janiero, in 1807/1808, and established the Kingdom of Brazil (1808–1821). While Brazil won its independence from Portugal in 1825, a full-scale attempt to develop its institutions for its own benefit would be delayed until became a republic, in 1889.[21]

[19] See John H. Coatsworth, "Economic and Institutional Trajectories in Nineteenth-Century Latin America," in *Latin America and the World Economy Since 1800*, ed. John H. Coatsworth and Alan M. Taylor (Cambridge: Harvard University Press and David Rockefeller Center for Latin American Studies, 1998); Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*.

[20] John DeWitt argues that, despite the Braganca King's declaration that "'Britain is Portugal's milch cow,'" the "milch cow was Britain's. Portugal was merely the milkmaid, skimming off a little cream before passing the brimming bucket to Great Britain." See John DeWitt, *Early Globalization and the Economic Development of the United States and Brazil* (Westport. CT: Praeger, 2002), 4.

[21] Rex A. Hudson, ed., *Brazil: A Case Study* (Washington, DC: Federal Research Division, Library of Congress, 1997).

Huge inequalities in wealth were characteristic of societies that were British (Barbados and Jamaica), French (Haiti), Spanish (Cuba and the Dominican Republic), or Portuguese (Brazil). These inequalities were built upon and maintained by repressive institutions. The heritage of British institutions and/or Protestantism was not enough to dissuade Britons from adopting slavery where it might pay off in the efficient production and harvesting of crops with high value on world markets. Britons in the southern section of North America, too, would embrace plantation agriculture staffed by slave labor, as shown in Table 6.6. Note that the social systems that were initially based upon outright repression, Groups I and II, were also the ones with the lowest provision of public goods and the least by way of opportunities for the development of human capital. Group V, which consists of the northern colonies in North America was the opposite, and Groups III and IV are intermediate.

Comparative advantages based upon plantation agriculture were at one and the same time the basis for high performance for the first 250 years and a key reason for resistance to reforms in the second 250 years. Huntington argues, as Chap. 5 explained, that there can be stability in a rural society (perhaps based upon repression) and stability once again in one that is industrial and urban, but the process of societal transformation is likely to be characterized by instability, where those with wealth in the rural economy try to delay or obstruct the transformation.

However, if one looks at Group I in a bit more detail, differences emerge that preclude any deterministic explanations. Brazil started out with huge land grants to induce early royal favorites to develop the northeast for agricultural purposes. State assistance was frequently necessary to get the development process started because it required considerable up-front investments, including the importation of slaves to develop the plantations and port facilities, and payment for military protection from attacks by the locals or slave insurrection. Large blocs of land were necessary to develop the economies of scale for efficient, slave-based plantations, and the use of force permitted the wealthy to develop comparative advantages for high-value crops based upon cheap labor. In the Portuguese and Spanish areas these repressive social systems were supported by centralized political systems in which top officials were appointed by the crown in the mother country. There was little development of the institutions of local political consultation until after the French Revolution. Jamaica achieved similarly repressive results through a very different process, as we will see below.

Spanish settlements in the Caribbean received less attention than those on the Mainland, once it became clear that there was little gold or silver on the islands, and this provided an opportunity for British takeover. Jamaica, originally a Spanish colony, was allowed to slip into British hands in 1655, and it was the British under Oliver Cromwell who would import slaves to develop its sugar plantations. When the first British settlers failed to establish viable settlements, Cromwell ordered the export of convicts and underage children from Ireland and Scotland. With restoration of the monarchy in 1660, Charles II offered Jamaica's British citizens their full rights, including the right to a local parliament and judiciary. Although much of the land had been distributed in small plots, Jamaica's natural advantages as a sugar producer led landowners to amass steadily larger plots, averaging 600–900 acres, to make slaveholding economical, and its laws were adjusted to permit this key institution.

Jamaica illustrates just how elitist a British colony could be. Its wealth per free (white) person in 1774 was almost 15 times that of the average wealth per person on the island, more than 12 times that of the average free person in the US South, and more than 20 times that of their counterparts further north. With a strategy of raising valuable export crops on plantations, one could call this system capitalistic for the slave owners, but not for the bulk of the population. With an estimated 250 slaves needed to achieve economies of scale, Jamaica imported more than 544,000 blacks between 1660 and 1780, a figure greater than all of the white immigrants to all of the colonies that would form the United States.[22] Between 1690 and 1740 the black population in Jamaica rose from 32,000 to 118,000, and the ratio of blacks to whites rose from 1.1:1 to 6.4:1 in 1703 and then to 9.9:1 by 1739.[23] As two historians describe it: "Jamaica was transformed in this period into a black country, a country in which Europeans were heavily outnumbered and where they retained their position only through massive applications of force, exercised through social and legal institutions and through the continuing presence of large numbers of British troops."[24]

This radical transformation was unintentional. While the importation of slaves was a policy choice, the near stagnation of white population growth from 1690 until 1730 was the result of modest immigration coupled with a low birth rate and a very high death rate. In one large parish, deaths outnumbered births by three to one for the period 1692–1744.[25] An earthquake, yellow fever, and malaria took their toll, which was higher on whites than blacks. Jamaica was transformed from a settler colony into a slave colony, and would thus be radically different from any of the southern states in the United States.[26] The fact that many of the large planters in Jamaica were also resident in Britain added to this difference.

British entrepreneurs in Jamaica faced risks from climate, disease, and the vagaries of international trade, and they also faced the risk of insurrections, which were put down on three occasions by British troops. Whites living in Jamaica gradually adopted a fortress mentality, which would not change easily once slavery was officially abolished. But the Europeans in Jamaica were indisputably rich in 1774 or indeed until the Napoleonic Wars, which interrupted British trade patterns. Despite this wealth, or perhaps because of it, they failed to develop any educational system on the island. Their children were packed off to England for school as teenagers, often with no tutelage other than the family's business agent, so they

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22 Kathleen E.A. Monteith and Glen Richards, eds., *Jamaica in Slavery and Freedom: History, Heritage and Culture* (Kingston, Jamaica: University of the West Indies Press, 2002), 83.

23 Ibid., 82.

24 Ibid.

25 Ibid., 80.

26 Ibid., 73.

failed to develop much by way of habits of citizenship let alone concern for the fate of Jamaica. During the wars, Britain lost its export markets on the continent to Napoleon's blockade, while acquiring new sugar producing islands at French expense, both in the Caribbean and in the Indian Ocean (Mauritius). Accordingly, Jamaica lost its preferred position in the imperial sugar trade, and its real-estate prices collapsed along with sugar prices.[27]

This change in market conditions, and the abolition of slavery in the British Empire in 1833, hastened a fundamental change in the relationship between Jamaica and the mother country. Whereas Jamaicans had been allowed a considerable measure of self-governance for a century, interference from London increased and the issues became much more significant. Jamaica proposed limiting the importation of slaves in the 1760s, in order to limit their presence on the island, but they were refused permission to do so by London, on the grounds that the sugar trade was a vital source of revenue to the state.[28] Once sugar prices tumbled, however, Jamaica became a protected, but high cost source of that commodity. At the same time, slavery came under attack in Britain on moral grounds. But Jamaicans saw slaves as property and the protection of property as a cherished right. Ironically even some of the blacks saw things this way. Some black Jamaicans had received their civil rights before emancipation; they were 10,000 strong in 1800. These free blacks and mulattos, who owned property and slaves of their own, cast their lot with the whites and "declared that 'the interests' of the white settlers 'were inseparably connected' with their own."[29]

Britain prohibited the slave trade in 1807, after prolonged and contentious debate, with the institution supported by the crown, the cabinet, and the House of Lords. Jamaica's parliament opposed banning the slave trade or slavery. When abolition was nonetheless voted in 1833, Jamaican opposition intensified. London then faced the need to enforce change in a colony that was several thousand miles away, and where the local political and economic leadership was adamantly opposed to the changes. Reform was all the more difficult in a context where the abolition legislation had never enjoyed overwhelming support in the United Kingdom. Attempts to enforce the new dispensation by brute force from London caused the fall of more than one government, but in London, not Spanish Town.

Although the legislation ending slavery is described as absolutely unambiguous, London was all but impotent to enforce its will.[30] For instance, while it was recognized that freed slaves would need to be educated as citizens and members of society, Britain provided almost no funds to support such education, and the Jamaican legislature followed suit. White planters opposed educating their field hands. Thus, most of the burden of implementation fell to church groups, and the

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[27] Samuel J. Hurwitz and Edith F. Hurwitz, *Jamaica: An Historical Portrait* (New York: Praeger, 1971), 55.

[28] Ibid., 88.

[29] Ibid., 140.

[30] Ibid., 120.

largest one, the Anglican Church, was also opposed to abolition. Schools, such as they were, were left to supplement charity with tuition charges, and the latter excluded many of the black children from enrollment at all. By 1864, only an estimated 13% of the black population was literate.[31] Education was not the sole focus of neglect. Parliament failed to enact any system to inspect food, regulate the water supply, or provide any public-health services. Whereas there had been 200 doctors on the island in 1833, the number would drop to 50 by the 1860s, and there would be none at all in rural areas.[32]

Although British legislation called for full equality of rights, the repression of the black electorate was easily achieved. A land tax was enacted by Parliament in Kingston, at a rate that would amount to about 10% of potential earnings from small plots. Jamaicans were barred from voting unless their taxes were paid, and a poll tax was enacted, along with a stamp tax. This system of disenfranchisement was effective: in 1863, only 1,457 of the 300,000 black Jamaicans—of whom 50,000 were freeholders—voted.[33]

Jamaica's white "capitalists" were especially opposed to the emancipation of independent black farmers. To retard their access to opportunity, the legislature authorized the killing of stray goats and pigs, and made it a crime to pick wild fruits and berries. The idea was that the masters would remain the masters, and the legislature duly authorized institutions to limit opportunities for blacks to become self-sufficient, let alone entrepreneurial. Control of the local legislature became their means of blocking London's proposals for normalization of relations with the former slaves, let alone the creation of additional opportunities to help rectify the injustices of the past. Indeed, "Obstruction, vacillation, and inaction marked the conduct of the legislature. The elite groups of Jamaica were expressing through the assembly their anger toward government policies imposed upon them without their consent."[34]

When London tried to impose prison reform on Jamaica, by an Act of Parliament, the Jamaican Assembly dissolved itself in protest, thereby making clear that it would no longer appropriate funds to defray the costs of public institutions, including the British troops on the island. When London proposed a harsh response, it was passed by a bare majority in Parliament, and the government of the day was forced to resign. Lukewarm support in Westminster meant that Queen Victoria's government lacked the power to impose reforms upon a dependent colony with an independent legislature of its own. The social revolution that could and should have occurred to implement the abolition of the subsidiary institutions of repression did not occur for more than a century, or until the 1960s. In the interim, England focused on free trade, and especially on its manufactured exports, and gave much less attention to its agricultural colonies; the latter were part of an abandoned mercantilist system.

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[31] Ibid., 124.
[32] Ibid., 126.
[33] Ibid., 127.
[34] Ibid., 134.

Jamaica experienced decades of economic malaise, with a standoff between the races, and finally even the white missionaries gave up on trying to bridge the culture gap between the races. Although more than 90% of the inhabitants were black, dark skin was held up as a stigma and light skin a sign of prestige.[35] Blacks who succeeded in securing an education and/or property were looked down upon by whites, but they, nevertheless, gained a foothold in the political process and used it to maintain their superiority over those who had been emancipated in 1833, who were generally darker-skinned.

When the former slaves appealed to London for help, they were turned down. In 1865, a militia fired on a peaceful march of black protesters, killing 7; in response, the protesters rioted, killing 18, and retreated, while rebels took to the countryside and killed two white planters. These incidents became known as the Morant Bay rebellion, and Jamaican authorities responded with ruthless force, burning more than 1000 homes and executing more than seven hundred members of the black community and beating and imprisoning many more, all in a period of about 2 weeks.[36] Frightened by what they thought was a narrow escape from rebellion, the whites opted for strong government and to ensure it, ceded power to London to govern them directly.

From 1865 until 1939 Jamaica was a crown colony ruled by a British governor who was accountable only to London. Like many colonies in that period, it was financed almost entirely by import duties and excise taxes—a regressive tax system where ability to pay played virtually no role in revenues. This system offered little by way of resources to finance public goods, thus restricting opportunities for the poor and repressed Jamaicans. Though race-based advantages were officially abolished, racism persisted. While "[s]lave society was based on the gulf that separated slaves from free men . . . when all were free, the separation, if not fixed, was continued. The 'classes', whether white or black, felt no empathy with the masses."[37]

Jamaica was arguably without capitalism or democracy even at mid-20th century. Maintaining social superiority by repressing a lower class could be more important than economic development to a frightened if not bigoted oligarchy. It is a pattern that we will see repeated in the US South in the century after desegregation, as detailed in Chap. 8.

Engerman and Sokoloff have pointed out that while details differed by colony, the overall picture of the New World was dominated by the presence or absence of rich factor endowments that could be exploited by forced labor. Jamaica illustrates their thesis. It was a colony which was neither capitalistic nor moving toward more egalitarian social structure—let alone democracy—yet it could perform well "on average" until about 1750, reaping gains for European inhabitants and their descendants. Jamaica also illustrates how perverted British institutions could become in the hands of a local oligarchy with little accountability to a preoccupied government in

[35] Ibid., 140.
[36] Ibid., 148 ff.
[37] Ibid., 189.

London. Thus, Jamaica appears to have been representative of a Group I colony, in spite of its British heritage and indeed continuing British supervision well into the 20th century.

The French colony of Saint-Domingue would also become one of the richest areas in the region and a major source of wealth for France prior to the Revolution. Saint-Domingue occupied the western third of the island of Hispaniola, while the eastern portion of the island, Santo Domingo, was held by the Spanish. In the 1780s, Saint-Domingue supplied 60% of the world's coffee and almost 40% of Britain and France's sugar imports. Briefly, the tiny colony led all of continental North America in production of exportable wealth.[38] The colony was also statistically dominant as a particularly unforgiving destination for slaves; a third of the entire Atlantic slave trade was routed to Saint-Domingue, and owing to harsh conditions and rampant disease, the slave population turned over completely every 20 years. A slave revolt in 1790–1791 brought Toussaint Louverture to power and succeeded in overthrowing the colonial regime and executing much of the European elite; in 1804, Hispaniola was united under the independent republic of Haiti, becoming "the first modern state governed by people of African descent."[39] Santo Domingo, however, quickly became a separate territory on the island, with a complex relationship to Haiti, its neighbor, and occasional occupier; it became the Dominican Republic in 1844, with the expulsion of its Haitian occupiers.

After 1804, the new Haitian regime would control immigration and prohibit foreigners from owning land, institutions which have been maintained with adverse long-term implications. Haiti and the Dominican Republic were both plagued by a century of unstable government, followed by brutal dictatorships.[40] Nevertheless, their paths diverged, a difference that Jared Diamond attributes largely to leadership. As Diamond explains, Haiti had the misfortune to be ruled by Papa Doc Duvalier, who ruthlessly suppressed all opposition, but created little beyond what he could steal. With little attention to public policy he allowed exports to languish, and the Haitians were forced to fell their trees to make charcoal for purposes of cooking. In the Dominican Republic Rafael Trujillo, also a ruthless dictator, nevertheless, promoted industrialization, even if largely for his own benefit. With industrialization there could be a more diversified and stronger export base. Joaquin Balaguer would use the exports to pay for liquid gas imports, thus providing an alternative fuel source to native timber. It was part of a far-sighted strategy. Balaguer prohibited logging on public land, shut all sawmills, and sent troops into the forests at night to shoot illegal loggers. He also provided propane burners free to low income residents so that they need not continue to burn charcoal for cooking. Balaguer also used bulldozers to clear mansions illegally constructed in public parks and enlarged public lands to protect the watersheds. This top-down strategy was complemented

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[38] "Country Profile: Haiti" (Library of Congress, Federal Research Division, May 2006), 2.

[39] Ibid., 3.

[40] Jared Diamond, "One Island, Two Peoples, Two Histories: The Dominican Republic and Haiti," in *Collapse: How Societies Choose to Fail or Succeed* (New York: Penguin Books, 2005).

by tolerance for many institutions built from the bottom up to improve the quality of local governance. Thus, while the incomes of Haiti and the Dominican Republic were about equal in 1900, the Dominican Republic had a more than 5–1 advantage a century later. A legacy of slavery and abusive vertical relationships had enduring effects on both societies, but still left room for variations where there was better leadership, as in the case of Trujillo and, much more, that of Balaguer.

Group II: Mexico, Peru, Chile

The countries in Group II were all Spanish colonies, initially governed largely through Mexico or Peru.[41] At first, the Spanish aimed for the exploitation of gold and silver, with the crown insisting upon its tax take in the proceeds. In addition, the Spanish colonized areas that were highly populated; they developed both Mexico and Peru and were late to develop areas such as Chile and Argentina, with the latter run from Peru.

In the populated areas the settlers were given large land grants and in some cases encomiendas, or the rights to a fixed payment from an urban community that was tied to the land. Since the previous Amerindian regimes had hosted similar regimes, these practices were neither novel nor automatically rejected. Feudal-like institutions were thus established in the Spanish areas, but unlike Europe, racial and cultural gaps developed between the feudal lords and their subjects. Engerman and Sokoloff note that rich factor endowments were associated with forced labor, slavery, and great inequality. In addition they note that

> [W]here there was extreme inequality, as in most of the societies of the Americas, political institutions were less democratic, investments in public goods and infrastructure were more limited, and the institutions that evolved tended to provide highly unbalanced access to economic opportunities and thereby greatly advantaged the elite. This mechanism, through which the extent of inequality affects the way institutions evolve, not only helps to explain the long-term persistence of differences in inequality among the respective societies, but it may also play a role in accounting for the differences in the growth rates of per capita income over the last two centuries.[42]

But all of the colonial regimes except those of British derivation, and even some that were British, were associated with top-down colonial control and thus very little opportunity for self-government or the development of capitalism. In addition, both the Spanish and Portuguese crowns reserved the rights to name local officials. While this began auspiciously enough in both cases, with some of the leading nobility sent to the New World to govern on behalf of the crown, the pattern would soon change in the Spanish colonies.[43] In 1557, the Spanish crown suffered the first of a string

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[41] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 12.

[42] Ibid., 4.

[43] Mark A. Burkholder and Lyman J. Johnson, *Colonial America*, 4th ed. (Oxford: Oxford University Press, 2001), 83 ff.

of five bankruptcies. Determined to continue its wars for territory in Europe, the crown acceded to the idea of selling the rights to hold office in the New World as a way to finance its European ambitions. As time passed, and the crown failed to recover sound finances, the process affected more and more administrative and judicial appointments, starting with tax collectors but moving up to finance officials who had responsibility for expenditures and regulations and eventually including the auction of the offices of the viceroys themselves. The constant search for more revenues in Spain as successive kings tried to conquer Europe was a recipe for a continuing drain of resources from the colonies to help finance these wars, and for systemic corruption in their administration and continuing oppression as well. The new incumbents often went into debt to win office, and it therefore behooved them to squeeze the necessary funds for debt repayment from their subjects. Thus, a pattern of corrupt colonial administration was added to the problems caused by the factor endowments, a pattern which contributed to a specific Hispanic historical legacy above and beyond the problems implicit in the initial conditions.

A recent history of colonial Latin America asserts: "The importance of the sale of offices and appointments to the composition of the bureaucracy and its activities cannot be overestimated."[44] Instead of choosing outsiders who might have some objectivity in how they would administer their territory, it was insiders who had the biggest incentives to bid, and they could hope to stay in office for a decade or more. "Given the modest salaries associated with most non-fee earning positions, the temptation to resort to extralegal sources of income was irresistible for many bureaucrats."[45] In effect, the crown was licensing members of elite local families to use official bureaucratic powers for personal enrichment. Local officials were part of a system where they could be expected to routinely abuse those that they were supposed to "serve." Since the officials were almost always of light skin, it was also a way to reinforce a none-too-subtle system of racism throughout officialdom in the Hispanic areas.

Though the particulars in Brazil were different, the ideas were much the same. Both Portugal and Spain emerged as weak countries after their period of overseas exploration, and they lagged far behind in experiencing the Industrial Revolution. At the same time they exported some of their worst institutions to the new world. Thus, nobility did not pay direct taxes on their land in "the peninsula" (Portugal and Spain), and their heirs in Latin America also escaped these taxes. In addition, the high bidders for official posts in the Spanish colonies could hope to help defray the costs of buying their offices through monopoly control of some sectors of activity, such as the sale of donkeys for transport.[46] Spanish and Portuguese officials were a separate caste as well as class; they were empowered to collect taxes with little or no obligation to provide public goods. This might not have been as bad as it sounds, because the Indians were not interested in formal trade because of

[44] Ibid., 86.

[45] Ibid.

[46] See Burkholder and Johnson, *Colonial America*.

pre-capitalist institutions such as self-sufficiency, reciprocity, and common ownership of land. However, colonial officials lost little time in devising special taxes, as in Jamaica, which had to be paid in cash so as to keep the Amerindians and any other poor people in perpetual servitude. The Amerindians had to participate in the market economy if for no other purpose than to earn cash to pay the taxes imposed by the colonial authorities. The narrative stories of these native people must have included more than 2 centuries of organized abuse, whether in slavery, feudalistic relationships, or perhaps less oppressive oligarchy. At the same time there was virtually no experience gained in the practice of local self-government or the development of human capital.[47] This contrast between Latin America and the United States in terms of the decentralization of responsibilities is suggested below, in Table 6.7, where federal and provincial governments raised more than 90% of the total in Brazil in the early 19th century, almost 90% in Mexico, and less than 50% in the United States, except in time of war.

Both the Spanish and Portuguese colonies had their regimes overthrown in wars of liberation in the 19th century. However, liberation tended to replace the repressive institutions of one era with oligarchic institutions of its successors, and the pattern of inequalities remained, as noted by the World Bank study. The pattern of inequalities has created tensions in most of these countries as they tried to establish democracy

Table 6.7 Distribution of tax revenues across levels of government, c. 19th century

	National government (%)	Provincial government (%)	Municipalities or other local (%)
United States			
1855	25.5	17.4	57.1
1875	39.6	16.4	44.0
1895	36.0	14.0	50.0
1913	29.1	13.2	57.6
1927	35.5	18.0	46.5
1950	68.3	17.3	14.4
Brazil			
1826	30.8	69.2	0.0
1856	79.5	17.1	3.3
1860	78.2	18.2	3.5
1885/86	76.3	18.5	5.2
Mexico			
1882	69.1	19.5	11.5
1890	74.7	16.3	9
1900	67.3	19.8	12.9
1908	70.6	17.1	12.3

Source: Adapted from Kenneth L. Sokoloff and Eric M. Zolt, "Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions," *Tax Law Review* 59:2 (2006), 229, Table 4

[47] Ibid., 87–90.

with oligarchic social systems. The problems of reforming such a situation are formidable, as we will see in Part III, when we examine the Old South in the United States before 1960 or indeed the Mezzogiorno right to the start of the new millennium. A state that provides public goods primarily for the benefit of its elites is very difficult to change; the elites want to retain their privileges while at the same time avoiding the taxation that would be required if more adequate public goods, such as better public schools and better law enforcement, were to be made more generally available to the population as a whole. It is a natural recipe foe underdevelopment indefinitely, barring some form of upheaval, as in the Dominican Republic.

Group III: American Colonies South of the Chesapeake

Engerman and Sokoloff list the US South as their middle case, between Groups I and II at one extreme and the US North at the other. I list it as Group III, which keeps it in the same place in relative terms. I do so with the sense that slavery in the south, though far from covering all of the farming areas, and constituting only a modest fraction of the labor force, presented a model more repressive than feudalism for that part of the population subjected to it. As a result, part of the population lived in a social system that was more repressive than Argentina or Uruguay, and far more so than that the US North. The US South was lucky enough to have an ample supply of mediocre land that was not suitable for plantation agriculture, for example, in much of what would become West Virginia. Yet, slavery was an extremely important institution that conditioned many things, from education to law enforcement to a disdain by whites for certain kinds of work. Furthermore it delayed urbanization and the development of manufactures. I defer this discussion until Part III, where I will consider how the south differed from the north, and how it would continue to do so long after slavery was abolished.

Group IV: Argentina, Uruguay, Chile

This leaves us with a temperate-to-cold weather model that has an Hispanic heritage in Latin America in contrast to one that is mostly British in the US North. Argentina is in fact a temperate-to-cold weather area not suitable for plantation agriculture and thus one with factor endowments that might have been developed along the lines of New England. Uruguay, not shown separately because it was not originally independent from Brazil, would seem to belong in this same group and perhaps Chile as well. All three had factor endowments more like the US North than their Latin neighbors in the more tropical climate zones. And yet Argentina parceled its land into large estates and its immigration was controlled by the Spanish, thus protecting the opportunities of early settlers to hold very large plots of land. Big land holdings were a source of very unequal wealth and incomes, and they entered these areas early as a matter of culturally conditioned institutions, not because of their factor endowments per se. However, with a very favorable land–labor ratio, Argentina would remain a high-income society until the early 1900s, thanks to the export of animal hides and grain. It was only in the 20th century that it would sink to third world status.

While emphasizing the role of factor endowments, historian John Coatsworth has argued that Latin America's Iberian heritage contributed to the adoption of a set of institutions that would prove to be disadvantageous relative to those adopted in the United States.[48] Coatsworth identifies harmful "institutional constraints [that] constituted powerful obstacles to economic growth throughout the Iberian word."[49] In particular, he notes the harmful constraints posed by "Political risk . . . from the arbitrary character of Iberian regalism and succeeding personalist and military dictatorships, the discretionary authority exercised by colonial and national officials whose private gain often took precedence over the public interest," as well as the "Iberian legal norms" which helped make "the costs and associated risks of engaging in productive economic activity, including commercial and other services . . . substantially higher than in the British colonies and former colonies."[50] Institutionally based differences also surface in the next chapter in the substantial delay in the development of literacy in Latin America. More specifically, southern Brazil might have been organized in a more egalitarian model because of its more temperate climate, and in today's terms these more temperate areas are surely home to far more people than the more tropical northeast, which was first to be settled. However, since all of Brazil was developed according to the Portuguese model, it was characterized the colonial model of centralized government and the under-provision of public goods that accompanied slavery further north. Rich factor endowments were a sufficient condition to produce social systems more repressive than European feudalism, thanks to forced labor, regardless of the national heritage of the colony, as for example, in Barbados and Jamaica. But rich, concentrated factor endowments were not necessary for the emergence of the oligarchic model; an Iberian heritage, or even French, in lower Canada, would lead toward this path, and thus depart from the British model in the US North.[51] It was a possibility not specifically considered by Engerman and Sokoloff.

Group V: American Colonies North of the Chesapeake

Engerman and Sokoloff list the American colonies north of the Chesapeake as their third, and most egalitarian, group of societies, and I have kept them in the same relative position but listed them as Group V. The northern colonies, whether British or French, lacked substantial concentrated factor endowments, whether human, metallic, or in terms of soil and climate. Thus, there was limited opportunity to

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[48] Coatsworth, "Economic and Institutional Trajectories in Nineteenth-Century Latin America," 23–54.

[49] Ibid., 34.

[50] Ibid.

[51] The French heritage in Lower Canada is discussed briefly in the next chapter.

mobilize political and/or military power to exploit their more modest resources. In these circumstances there was little reason for large land holdings, as they lacked economies of scale, i.e., from forced labor. The exemplar was William Penn, who had a vast grant in what would become Pennsylvania. Penn's grant was of only modest value because it had neither precious metals nor a climate that was suitable for high-value crops; it was suitable for mixed farming with grains and livestock, but without big economies of scale. Thus, this part of the New World came to be characterized by family farms, with little if any hired labor, as will be discussed in Chap. 7. At the same time slavery was widely permitted and practiced, but typically on a very small scale. Group V was thus emphatically what might be called settler colonies.

Unlike in Latin America, Europeans were in the majority in North America before 1800, and they tended to create institutions to govern a homogenous population where land and other forms of property were relatively equally distributed. Once trans-Appalachian settlement was organized, land holding became still more egalitarian as a matter of public policy, for example, in the Northwest Ordinance. Engerman and Sokoloff found that "great equality or homogeneity among the population led, over time, to more democratic political institutions, to more investment in public goods and infrastructure, and to institutions that offered relatively broad access to economic opportunities."[52]

Trajectories of Development in Latin America

Capitalism was delayed and stunted throughout Latin America until the late 19th century by the presence of colonial and then authoritarian regimes that wished to "protect investors from unscrupulous promoters" but even more to keep power and therefore capital concentrated in the hands of the local elite. Severe limitations on private rights to mobilize capital were a crucial factor in retarding the development of Latin America. For example, Brazil did not allow a statute of limited liability for corporations until after the monarchy was overthrown in the 1880s, nor did it allow the free chartering of banks, or banks to own shares or individuals to buy shares on margin.[53] With these restrictions its nascent textile industry was unable to raise significant amounts of capital through public offerings of stock. Indeed there were only two joint stock firms in the textile industry in 1883. By the same token, banking was tightly restricted, with its first priority to finance the crown. In 1888 there were only twenty-six banks with total deposits amounting to about US$48 million, but half of the deposits were in Rio alone and seven of the states had no banks at all.[54]

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[52] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 4.

[53] Stephen Haber, "The Efficiency Consequences of Institutional Change: Financial Market Regulation and Industrial Productivity Growth in Brazil, 1866–1934," in *Latin America and the World Economy Since 1800*, ed. John H. Coatsworth and Alan M. Taylor (Cambridge: Harvard University Press and David Rockefeller Center for Latin American Studies, 1998), 282.

[54] Ibid.

Potential Brazilian entrepreneurs were thus unable to gain access to bank credit or equity finance comparable to that available to their US counterparts. Much the same circumstances existed in Mexico until the Revolution of 1910 overthrew the dictatorship of Porfirio Diaz, and for similar reasons.[55]

Extending Capitalism in Brazil

Did these institutional handicaps really matter, or were there other more salient causes for Latin American underdevelopment? Stephen Haber has noted that times of dramatic change cast the linkages between institutions and performance into relief; otherwise one could endlessly argue about causes. As for Brazil, reforms began in 1882, when the government gave blanket permission for joint stock companies. But with no provision for limited liability, this liberalization had little impact. According to Haber: "The real impetus to regulatory reform did not get underway until 1888, when the imperial government abolished slavery. The end of slavery produced a series of unexpected and unintended outcomes that set in motion both the overthrow of the monarchy and the complete reform of banking and securities market regulation."[56]

The new republican government deregulated banking and ended subsidized loans for 17 of the banks; it limited shareholder liability and "instituted a set of mandatory disclosure laws that were highly unusual for the time. Brazil's publicly owned corporations were required to produce financial statements annually . . . and reprint them in public documents."[57] The market response was dramatic. The number of spindles in the textile industry more than tripled between 1883 and 1895; the nominal capital of firms listed on the Rio de Janeiro and Sao Paolo stock exchanges doubled between May 1888 and December 1889, and doubled again by December 1890.[58] Unfortunately, a rash of newly incorporated banks soon went bust. Brazil's liberalized but poorly regulated financial sector was a forerunner of difficulties in other countries. So the notion of reform seems to matter a great deal; the reforms in the 1880s brought dramatic and almost immediate change. Faulty reform, while potentially very costly, may still be an improvement on the previous sclerosis.

Extending Capitalism in Latin America

The World Bank has noted that economic inequality in Latin America was not only an issue of economic injustice on the demand side, but also an indicator of truncated opportunities on the supply side

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[55] See Haber, "The Efficiency Consequences of Institutional Change: Financial Market Regulation and Industrial Productivity Growth in Brazil, 1866–1934."

[56] Ibid., 283.

[57] Ibid., 285–286.

[58] Ibid., 286.

> These differences in income are so large as to imply not only huge differences in standards of living, broadly conceived, but huge differences in opportunity to earn that living as well. These differences emanate from differences in the resources available to rich and poor, in police differences in protection based on who they are and what they earn, and in the prospects for relief if society has in some way wronged them.[59]

In its study of the sources and implications of inequality in Latin America, the World Bank also noted issues of race, ethnicity, and gender discrimination; unequal public expenditures and regressive taxation; unequal distribution of land and education; unequal access to markets; and likewise unequal access to remedies through the political process. The mix of causes is obviously different from country to country, but important uniformities persist

> At the end of the 20th century, most Latin American states still conformed most closely to a model of patronage and clientelism that was embedded within a broader pattern of unequal societal relationships, albeit with islands of high levels of high levels of technical competency. This pattern is associated with high degrees of inequality of influence, with disproportionate influence over the state by wealthy individuals and corporations while poorer groups typically interact with the state through vertical relations of patronage, or are excluded. Few states have effected the transition to programmatic parties and autonomous bureaucracies that [was] a feature of institutional change in much of Europe and North America. This is further reflected in the relatively weak capacity of Latin American states to deliver key public goods . . . and services financed by taxes.[60]

Are there present-day legacies from this earlier period, above and beyond the clientelism, extrajudicial relationships, and paucity of public goods and services noted above? I pick three issues, the decentralization of government, the underdevelopment of domestic financial resources, and the underdevelopment of scientific personnel and patents, to illustrate just how far behind Latin America is, and to suggest the nature of the causality.

Centralization of Government

Latin America faces problems of capacity and accountability when responding to local needs. For example, its police forces are typically controlled at the state or federal levels, quite in contrast to the United States where they are controlled primarily at the local level and backed by the states. Education is similar, with the United States characterized by almost 15,000 school districts with their own taxing authority. Local government is no panacea, but for communities with educated voters it can serve as a continuing school for citizenship. Table 6.7 shows just how centralized government has been in Latin America by comparison. Prior to the 1930s the basic unit of government in the United States was local government, not federal or state. Latin America was almost the opposite.

Why would there be such huge differences as suggested in the table? My hypothesis is simple. With distributions of wealth along the oligarchic, if not the feudalistic,

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[59] de Ferranti et al., *Inequality in Latin America and the Caribbean: Breaking with History?*
[60] Ibid., 5–6.

Table 6.8 Comparative structures of tax revenues as a share of GDP

	Latin America and the Caribbean		Developed countries
Tax category	1990–1994	1995–1999	1991–2000
Income taxes	3.6	3.4	9.7
Individual	0.5	0.9	7.1
Corporate	1.9	1.7	2.3
Social security	2.5	2.9	7.8
Taxes on goods and services	5.6	7.4	9.5
VAT and sales	3.2	4.8	6.5
Excises	2.1	2.3	3.0
Trade taxes	2.2	1.8	0.3
Imports	1.9	1.8	0.3
Exports	0.1	0.0	0.0
Property taxes	0.4	0.3	0.8
All taxes	14.2	16.1	28.7

Source: *Inequality in Latin America and The Caribbean: Breaking with History?* eds. David de Ferranti, Guillermo E. Perry, Francisco H. G. Ferreira, and Michael Walton (Washington DC: The World Bank, 2004), 252, Table 9.3. Reproduced with permission of World Bank.

model, Latin American oligarchs resist direct taxation, whether of their incomes or wealth. This resistance shows up in Table 6.8, where Latin American tax revenues are low compared to those of developed countries as a share of GDP, and where, further, the fraction collected through direct taxes on incomes or property is lower still. Revenues from income taxes are only a small fraction of those collected by developed countries, all measured as a fraction of their respective GDP figures, and property taxes yield about half the revenues of the rates exacted in developed countries. Such resistance to direct taxation leaves governments more dependent upon indirect taxes, such as sales, value added, or excise taxes, which are more properly collected at higher levels of government, where they cover a greater area and are therefore harder to circumvent. However, indirect taxes are typically regressive, which tends to limit the resources available from such sources, and hence to such governments as depend heavily upon them. This has several unfortunate effects. It makes state and federal governments less accountable to local citizens, spurring a vicious circle. Regressive taxation limits available revenues, thus limiting the availability of public goods, especially education, public-health services, and physical infrastructure, especially in poorer areas. It also limits the funds available to pay public servants such as police, public prosecutors, judges, and even tax collectors. So a paucity of public goods are badly administered as well, all of which discriminates against those of modest means. Milton Friedman's notions of freedom from government as a route to a better life simply do not connect with this reality. They help rationalize the old elitism.

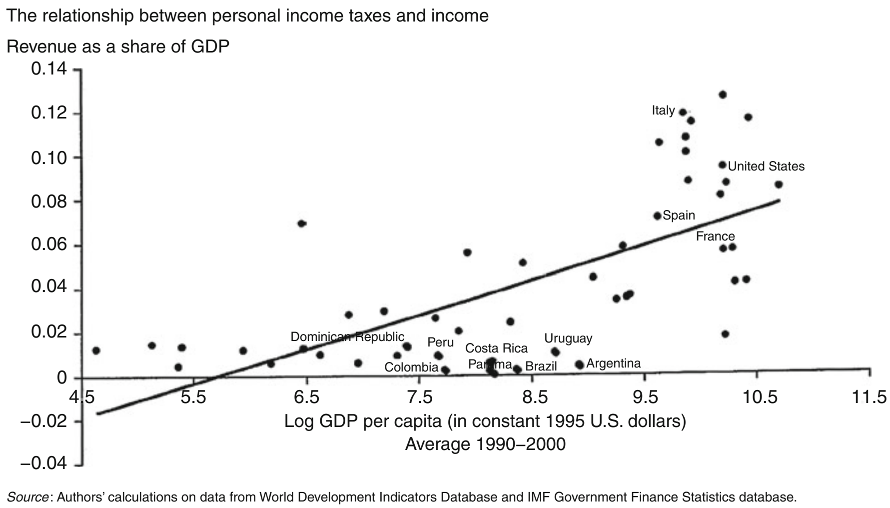

Fig. 6.2 Revenue collected from income taxes, as a share of GDP. Source: *Inequality in Latin America and The Caribbean: Breaking with History?* eds. David de Ferranti, Guillermo E. Perry, Francisco H. G. Ferreira, and Michael Walton (Washington DC: The World Bank, 2004), 257, Figure 9.5. Reproduced with permission of World Bank

In a related development, Latin America appears to be about at the bottom in terms of revenue collected from income taxes as a share of GDP when compared to a sample of other developing countries, as shown in Fig. 6.2. The positions of Argentina, Brazil, and Uruguay are particularly flagrant in this regard, and Mexico and Chile are not shown. None of these relationships are unknown to the Latin American students that I have in class. They recognize that the wealthy pay little in direct taxes, and that the poor receive little by way of protection from their law-enforcement systems. From the point of view of poor people these relationships cannot appear legitimate, which can be expected to create political problems when it comes to law enforcement, a possibility that seems beyond the field of vision of de Soto.

This pattern of public financing maintains a framework conducive to the continuation of the very sort of abuses that originated with bankruptcy of the Spanish crown in the 16th century, i.e., the use of public office as a way to exploit the public rather than to serve it, and the perpetuation of corruption as a route to power for those who are lucky enough to rise in the political systems. And it may not be coincidental.

Latin America also ranks near the top in terms of the perceived corruption of its political financing, as shown in Fig. 6.3. It also ranks near the top in perceptions of the extent of private sector capture of the regulatory processes for their own benefit and/or protection. This is a combination of circumstances that one might have expected in the 16th century, with a corrupt bureaucracy abusing the poor while allowing the rich to avoid their fair share of the tax burden. East Asia is a striking

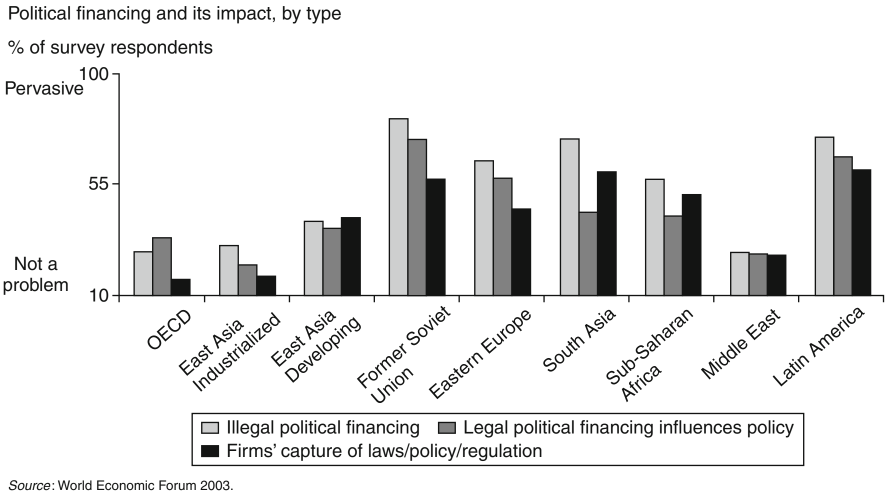

Fig. 6.3 Perceived corruption of political financing. Source: *Inequality in Latin America and The Caribbean: Breaking with History?* eds. David de Ferranti, Guillermo E. Perry, Francisco H. G. Ferreira, and Michael Walton (Washington DC: The World Bank, 2004), 128, Figure 5.2. Reproduced with permission of World Bank

contrast; it has better scores on these measures than the developed countries, and far better scores than any areas in the developing world.

Indicators of Financial Development

Latin America also lags in its financial development, or the capital that it can raise from domestic resources. One measure of this underdevelopment is the extension of credit to the private sector. Latin American financial institutions have demonstrated very little capability or willingness to lend to their own private sector, for example, in comparison with five East Asian counterparts who, on average, had lower incomes. An un-weighted average for eight Latin American countries shows credit to the private sector rose from 30% of GDP in 1980 to 39% 18 years later; a group of East Asian countries were able to expand credit to their private sector from 49% of GDP to 113% during the same period.[61]

Lack of availability of credit to the private sector is an important problem, and arguably more so than the capitalization of local stock markets, but I have not found any clear analysis of why it exists. Simon Johnson and Andrei Shleifer examined the comparative development of financial markets in Poland and the Czech Republic during the 1990s and noted that the people devising the regulatory policies sometimes lost sight of a basic truth: "Perhaps the single most important 'transaction

[61] The World Bank, *World Development Indicators 2000* (Washington, DC: The International Bank for Reconstruction and Development/The World Bank, 2000).

cost' in many countries is the cost of contract enforcement."[62] There can be any number of specific causes, from particular institutions that are dysfunctional to legal systems that are overloaded, unresponsive, or unaccountable. Mexican financial institutions, which had the lowest such ratio among the countries listed in the table, were reported to demand collateral in excess of 100% on their small loans because of the difficulties of collecting in the event of default. While this might appear to be a dysfunctional institution (excessive collateral requirements) it is more likely a reflection of a systemic problem. Mexican financial institutions find it so slow and uncertain to pursue debtors in court that they prefer to extend credits to their government, even if the apparent rates of return are lower. One has to adjust for the costs of collection including the risks of non-collection.

At the same time, Mexican banks have been hampered in attracting deposits by the previous experience of their depositors in the confiscation of these deposits, for example, in time of a currency crisis. So, one could say that they lacked capacity to attract deposits due to previous confiscations and lacked a willingness to extend what funds they had, given the difficulties to be expected in effecting collection. This is only a hypothesis, but it suggests that the lack of capacity to convert assets into capital is hardly a problem that is confined to the poor, or to the failure to mobilize real-estate for mortgage borrowing. The problems are systemic.

Table 6.9 shows that Latin American financial systems suffered from much higher interest rates spreads—as shown by a larger difference between lending and deposit rates—and higher external risk premia—as shown by higher spreads over LIBOR—than their counterparts in East Asia and the G-7. Higher interest rates spreads could be a sign of banking inefficiency, but also of risk premia associated with difficulties in collection. Differentials relative to LIBOR reflect a combination of inflation differentials and currency risks. But whatever the exact causes, these tables show that credit to the private sector is much more expensive in Latin America than in East Asia and much less used.

Science and Technology Indicators

Measures of financial development are an important indicator of deep-seated weaknesses in Latin America, but hardly the sole one. Indicators of technical resources are similarly bleak across Latin America. In scientific personnel per million none approach Korea or Singapore. (Measures of financial development need to be set against science and technology statistics as indirect indicators of potential demand for those financial resources, which have long been weak in Latin America. I do not have these indicators, included in the 2000 World Bank *World Development Indicators*, at hand as I finish up this book, and do not wish to delay publication further in searching for them.) In addition, Argentina, Brazil, Chile, and Mexico have very low technological specialization of their exports compared to the East Asian

[62] Andre Shleifer and Simon Johnson, "Coase v. the Coasians" (Harvard Institute of Economic Research Working Paper 1885, November 1999).

Table 6.9 Interest rate spreads in East Asia, Latin America, and the G-7

	Lending-deposit rate (%)			Spread over LIBOR (%)	
Country	1990	1998	2001	1990	1998
East Asia					
Average	2.4	1.7	3.2	3.9	7.1
Latin America					
Bolivia	18.0	26.6	10.2	33.5	33.8
Chile	8.6	5.3	5.7	40.5	14.6
Colombia	8.8	9.7	8.3	36.9	36.7
Costa Rica	11.4	9.7	12.1	24.2	16.9
Ecuador	–6.0	10.2	8.9	29.2	44.0
El Salvador	3.2	4.7	4.6	12.9	9.4
Guatemala	5.1	11.1	10.2	15.0	11.0
Honduras	8.3	12.1	9.3	8.7	25.1
Nicaragua	12.5	10.9	13.8	13.7	16.0
Panama	3.6	4.1	4.1	3.7	5.2
Paraguay	8.1	14.0	12.0	22.7	24.4
Venezuela	7.7	11.5	6.9	27.2	40.8
Average	7.4	10.8	8.8	22.4	23.2
G-7					
Average	4.1	3.4	3.8	3.4	1.3

Note: "East Asia" includes China, Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, and Thailand. "G-7" includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
Source: The World Bank, *World Development Indicators, 2000* (Washington, DC: The World Bank, 2000); The World Bank, *World Development Indicators, 2003* (Washington, DC: The World Bank, 2003)

countries and, other than Mexico, have made little progress in this regard since 1977.[63] This gap in scientific capabilities is even more apparent when it comes to measures of output, such as the generation of US patents. In 1998 Korea and Taiwan each generated more than 15 times the US patents than four of the leading Latin American countries combined, and this is not adjusted on the basis of population (see Table 6.10).

Why such a lag in scientific personnel, patents, and high technology export performance? There are no simple, technical answers. Weak educational systems are arguably an important contributor to these self-reinforcing trends. While no solid statistics on early education in Latin America could be found, the literature describes a meager provision of schooling. Historian John Coatsworth identifies a lack of public goods, especially investment in "human resources and physical infrastructure" as one of several institutional constraints operating in the "Iberian colonial

[63]Ludovico Alcorta and Wilson Peres, "Innovation Systems and Technological Specialization in Latin America and the Caribbean," *Research Policy* 26: 1998.

Table 6.10 Patents granted in the United States: Latin America versus East Asia

	1985	1998	Persons per patent, 1997 (thousands)
Argentina	12	46	778
Brazil	30	88	1,870
Mexico	35	77	1,267
Venezuela	15	29	772
South Korea	50	3,362	13
Taiwan	199	3,805	5

Source: United States Patent and Trademark Office, Patent Technology Monitoring Team Special Report: "All Patents, All Types; January 1977–December 1998," March 1999 (http://www.uspto.gov/web/offices/ac/ido/oeip/taf/apat.pdf)

regimes and their successor states."[64] Local governments found some opportunity to flourish despite colonial rule, and many villages had "wide latitude to manage their own affairs."[65] But local and state governments, under colonial rule and after independence, were either "not willing or able" to invest in widespread primary education.[66] Colonial government neglected primary education, leaving schooling to the Church,[67] which established elite and selective educational institutions and universities in the towns and cities of the colonial administration, perpetuating a rural/urban educational dichotomy.[68] Thereafter, in the absence of local responsibility, the burden of providing schooling fell to the state and national governments, which were slow to fund the endeavors. In the New World, the United States and Canada set a high standard in primary schooling and literacy, and the Iberian colonies—as well as the British colonies in the Caribbean, which did not promote schooling until the 1870s—trailed behind. While most of Latin America achieved its independence 40–50 years after the United States, Argentina and Uruguay, "the most progressive Latin American countries," nevertheless lagged 75 years behind the United States and Canada in promoting schooling.[69]

The discrepancies in investment in education between the northern Atlantic colonies and Latin America cannot be fully explained as arising from differences in cultural heritage, religion, or even income. Both Iberian and British colonies failed to promote schooling in Latin America. While Catholicism was a prevalent force in Latin America, Protestantism was prominent in the British Caribbean; and the

[64] Coatsworth, "Economic and Institutional Trajectories in Nineteenth-Century Latin America," 34, 33.

[65] Ibid., 40.

[66] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 27.

[67] Coatsworth, "Economic and Institutional Trajectories in Nineteenth-Century Latin America," 34.

[68] Colin Brock, "Latin America: An Educational Profile," in *Education in Latin America*, ed. Colin Brock and Hugh Lawlor (London: Croom Helm, 1985), 3.

[69] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 27.

strong Catholic influence in French Canada did not translate into a disregard for education.[70] Finally, high per capita incomes existed throughout the New World. Rather, prominent economists have attributed the early encouragement of education in the United States and Canada to economic and political equality and ethnic homogeneity.[71] Conversely, the promotion of education in Latin America stalled because of inequality. Within Latin America itself, "those countries that were leaders in public provision of education, and in the attainment of high rates of literacy—Argentina, Costa Rica, and Chile ... generally had relatively greater equality in the distribution of income, human capital, and political power, probably throughout their histories since European colonization."[72]

Mediocre universities are part of the story, but also a lack of scholarship opportunities for bright students from low socioeconomic backgrounds, which then limit the supply of technically trained talent to draw upon. Furthermore, these countries lack opportunities for gifted people to pursue their interests in clusters where universities work in close proximities to high technology firms. In the US, as in East Asia, patent development is increasingly built from a scientific base in and near universities and research labs in clustered communities, such as Silicon Valley, the Route 128 area around Boston, or Austin, Texas. Faculty and graduate students become risk takers, using subsidized equipment provided by the universities, often with private sponsorship as well. Latin American universities, typically sponsored by the state, are hampered by less generous budgets for faculty or equipment, a concern about conflicts of interest associated with private contracts for research, and sometimes by a disdain for applied research, as well. But, as suggested by Table 6.10, none of the leading Latin American economies are even in the same ballpark with their East Asian rivals when it comes to creating intellectual property. In 1985 one might have wondered if the Latin Americans and East Asians were on similar developmental trajectories, at least as measured by patents granted in the United States. Fifteen years later there could be little doubt that they were not.

Underlying all of these indicators are the same basic factors identified at the beginning of this chapter in terms of Latin American priorities, i.e., a neglect of development of their domestic resources through a failure to provide broad-based educational opportunities, and the limited availability of credit throughout their private sectors and not just to poor people. If profits and profitability are the incentives as well as the fuel that drive capitalism, credit that is scarce and very high in relative cost arguably remains a cause of underdevelopment with its roots in distorted and underdeveloped factor markets. Furthermore, exceedingly weak law enforcement throughout the region leaves the poor at the mercy of the rich. Oligarchic abuse is the norm, and the rich fortify their homes rather than trying to correct the manifest inequalities.

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[70] Elisa Mariscal and Kenneth L. Sokoloff, "Schooling, Suffrage, and the Persistence of Inequality in the Americas, 1800–1945," in *Political Institutions and Economic Growth in Latin America: Essays in Policy, History, and Political Economy*, ed. Stephen Haber (Stanford, CA: Hoover Institution Press, 2000), 162.

[71] Ibid., 170.

[72] Ibid., 197.

Conclusions and Implications

The development of Latin America has been strongly influenced by the factor endowments that were discovered and exploited early in the colonial period. These factor endowments led to the creation of comparative advantages based upon productive systems, both in mining and in plantation agriculture, that were based upon forced labor. The maintenance of systems based upon forced labor necessitated the creation of political institutions even more repressive than feudalism.

The success of the Latin American colonies over their first 250 years testifies to the power of rich factor endowments and "free trade in product markets" to induce the creation of comparative advantages, exports and economic growth. Available data suggests that Brazil and Mexico had slightly higher growth rates than France, Portugal, or Spain from 1500 until 1820, though the differences were too small to allow much of a catch up. On the other hand, Britain and the Netherlands grew much more rapidly than any of the foregoing five countries. Still, British, Dutch, French, Portuguese, and Spanish settlers were all attracted to the tropics where there was the potential to get rich despite the fact that average incomes in the colonies were far lower than in the home countries. Exploitation of comparative advantages allowed a few people to get rich, but the production systems were based upon plantations and mines where a few repressed the many, which was in turn backed by the repressive powers of the state. The prime beneficiaries were the European settlers and their descendants. Europeans were a minority of the population in the formative years: less than 10% in 1650 in the Spanish areas and in Brazil, and only 12% in North America, because Amerindians were still about 85% of the population in the Spanish and British areas, and about 80% in Brazil.[73] The history of the settlement of Latin America is a remarkable example of what can happen when the priorities of the production system create the institutional base for the political system because the European colonial masters and their local representatives had the coercive power to make it so. Once again, trade and comparative advantage can give one a superficial perspective on development when compared with the production paradigm explained in Chap. 2.

By 1825, or on the eve of the abolition of slavery in the British areas, most of Latin America was still characterized by the dominance of the European minorities. Europeans constituted 18% of the population in the Spanish areas compared to 22% black; Europeans constituted 23% of the population in Brazil compared to 55% black. In these circumstances it is arguable that both of these societies were still exploiting their comparative advantages in global markets based upon economic systems that were not yet capitalistic. More than two thirds of their inhabitants were denied the opportunity to use their full talents to advance their own welfare through participation in "free markets." And, unlike in North America, independence did not make a great deal of difference in these arrangements

[73] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, table 4.

> Despite the rhetoric of the revolutionary movement—and the fact that nearly all of the new countries were nominal democracies—the political break from Spain appears to have yielded little or no reduction in the extent of inequality throughout the continent as a whole. Indeed in most of Latin America inequality probably increased during the following decades.[74]

Whereas Hernando de Soto would claim that Latin America had its markets and was capitalist before the arrival of the Spanish I would suggest that it still had little by way of factor markets for land or labor 300 years after their arrival and still did not deserve to be considered capitalist. There was trade in the product markets, in circumstances where the bulk of the population had little if any access to the opportunity to develop its most basic resources, the human resource, because stunted and distorted states failed to provide such opportunities. At the same time theirs was a system that provided remarkable opportunities for a wealthy few to extend their talents without concern for the mediocre masses, i.e., a model much like the one advocated by Milton Friedman and Ayn Rand. The talented, and especially the well-connected and talented, could live like Europeans in a different civilization from their servants, field hands, and indigenous people because they had retreated beyond the reach of the market economy. The Latin Americans had created a recipe for the exploitation of the many by the few, thanks to systematic under-provision of public goods and services such as education, police protection, and access to transportation. The Latin American formula was an institutional recipe for continuing underdevelopment and substandard performance.

The United States and Canada also had slaves, but their populations were comprised of almost 80% European stock, with 17% black and less than 4% Amerindian. Given that the Europeans were overwhelmingly free persons by 1825, one can safely say that North America had a more homogenous population than Latin America as well as vibrant capitalist economies where about 80% of the population could participate. This meant that roughly 80% of the population in the United States and Canada had the chance for upward mobility on the basis of work, saving, and investment. In addition, the United States and Canada were among the leaders in providing public education to enhance such opportunities, and likewise in providing legal protections for the persons and property of the vast majority of their inhabitants. They were developing their human as well as their capital resources and were much the richer for it, even if their comparative advantages were much less obvious and less valuable than those in Latin America at least until the 1850s or so.

With the quickening of the Industrial Revolution from 1750 onward Europe and much of North America were able to industrialize and urbanize much more rapidly than Latin America This experience suggests that access to market opportunities, even during the so-called first era of globalization from 1850 to 1914, was not much of an opportunity for most Latin Americans. It was an opportunity for small enclaves to prosper from the trade in exports and imports, but the refusal of the wealthy to pay taxes meant that this trade produced little yield in terms of improved public goods

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[74] de Ferranti et al., *Inequality in Latin America and the Caribbean: Breaking with History?*, 112.

or indeed opportunity for human development. Compare this early form of globalization, say from 1870 until 1914, with the opportunities more recently offered to the countries of central Europe when they qualify to join the EU. By signing on to tens of thousands of pages of regulations, the weaknesses of their democratic traditions are skirted. They either modernize in a formulaic pattern or they are denied admission.

Engerman and Sokoloff suggest that a legacy of early settlement was built into the laws and institutions which would stunt their development for the short run, but in reality it is a set of institutions that require radical overthrow if there was to be far reaching reform. Achieving a nominal democracy is not remotely the same opportunity for reform as joining an already, modernized system. Unfortunately the United States has never seen fit to recognize such a difference. Free trade and foreign investment are assumed to be enough to bring about the market-based reforms. The Washington Consensus reforms were built on an exceedingly shallow understanding of how societies develop, whether capitalist or not. Deregulation, as espoused in this Anglo-American-based formula, amounts to an open invitation to abuse the system or the commercial commons. That is hardly a compelling formula of what is needed in countries that have experienced centuries of abusive behavior by their elites already.

In reality the European settlement of Latin America started the latter off with a distorted set of institutions favoring a small group of elites. These institutions systematically restricted access to public goods and opportunities for upward mobility for a large fraction of society. Implemented through concentrated economic and political power, these institutions were maintained by the oligarchic elites who controlled the economic and political power, and for more than 3 centuries. Whereas Europe would move from the feudalism toward oligarchy as it developed its capitalist systems between 1500 and 1800, the European entrepreneurs who went to Latin America created and administered societies based upon overt oppression during this same period. Surely it would make an interesting research project to try to determine when and under what circumstances one could say that the various Latin American economies had achieved "capitalists systems" that provided much by way of opportunities for the majorities of their respective populations.

My argument is not that the pattern of European settlement sealed the fate of Latin America; the inhabitants of the Dominican Republic have come much closer to escaping from their fate than their neighbors on the other side of the Island, in Haiti. Rather, I argue that the early pattern of product and market specialization chosen by the European settlers and their respective governments led to the entrenchment of a very distorted set of institutions that have proven exceedingly difficult to reform, even once it became clear that they were dysfunctional as well as immoral by present standards. Furthermore it should be obvious that free trade by itself has little capacity to induce the institutional reforms that are needed. Only a political process can induce institutional reform, and unfortunately the United States has rarely been on the side of such reform in Latin America. Part III of this book will explore two comparable situations in developed countries, Italy and the United States, where Italy's Mezzogiorno and the south of the confederacy were once organized as somewhat less comprehensive versions of the Latin American model.

By the same token I would argue that Latin America's problems lie essentially outside the field of vision of economists such as Milton Friedman and Hernando de Soto. The institutional problems confronting Latin America lie primarily in their still distorted factor markets and their paucity of public goods. More voluntary trade in the stalls of their local markets will make little difference, and a supply of deeds and titles will not be adequate to correct the political problems that affect their factor markets. Indeed, the principal beneficiaries are likely to be large firms in the more advanced capitalist countries, e.g., the integrated food producers and Wal-Mart's from the US and Europe. Political reforms will be required. Economists such as Friedman, who credit Pinochet's reforms to markets, have an ability to overlook the brutal way that the previous market frameworks were overthrown, and left wing elements were either executed or driven from the country. The result is a radically changed set of market foundations, but they were achieved at the point of a gun and not the sharp pencils of accountants or bonds traders, and this process threatens to simply further entrench the traditional, dysfunctional inequalities.

For more than a century Latin America has been trying to achieve capitalism and democracy at the same time, a very difficult feat in any circumstances and a heroic challenge given the prevailing oligarchies in one of the world's most oligarchic contexts. Oligarchy as it exists in much of Latin America is arguably incongruous with democracy; it robs domestic institutions of legitimacy while at the same time it does little to help the population develop their resources in other than minimalist fashion. A piece of paper may serve as an indicator of ownership, but that is different from the same certificate of legitimate ownership in a regime that is legitimate and able to provide its population with certain basic necessities for personal development, starting with an adequate education and an adequate system of law enforcement.

Chapter 7
Creating Capitalism and Democracy in the United States, 1630–1830

Co-authored by Sarah Potvin

Introduction

Capitalism and democracy developed simultaneously—and under exceptional circumstances—in the North American colonies of the New World between 1630 and 1830. In this chapter, I argue that the relatively egalitarian structure of wealth and power north of the Chesapeake hastened the emergence of a capitalist democracy, where new forms of political and economic governance were created almost simultaneously in power structures that were extraordinarily egalitarian and decentralized. These egalitarian relationships were assiduously cultivated by some of the key political leaders north of the Chesapeake, with the result that a symbiotic relationship would develop and flower there, while there would be a very different outcome south of the Chesapeake even though the respective colonies were united as one country, under a single constitution.

This chapter will focus less on this division between the northern and southern experiences, and more on the trajectory of development in America north of the Chesapeake, a trajectory particularly marked by early institutions that were consciously designed to promote and perpetuate that early egalitarianism. In keeping with the theory of development expressed in Chap. 4, I will not assume that these institutions sprang, fully-formed, from the conditions of the colonies; rather, I will examine the role of political actors in promoting economic development and bringing about democratic governance through the establishment of institutions unique to the American context. This rounded inquiry into the actors and conditions of early America will ultimately touch upon the economic, legal, political, and social frameworks extant.

In its focus on egalitarian institutions as preconditions to capitalism in North America, this chapter builds on previous investigations of early American capitalism

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Bruce R. Scott, "Capitalism and Democracy in a New World," Harvard Business School Case No 9-706-030. This case was prepared by Sarah Potvin and Alison Adams under the direction of Bruce R. Scott as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Reprinted by permission of Harvard Business School.

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_7,

such as that of William Cronon, a professor of early American history. One of my particular concerns is to identify when the institutions of capitalism seem to have first appeared in the United States, and how this experience might contrast with that of South America in a comparable time frame. In his 1983 study of early North America, Cronon connects the colonists' conception of land as tradable property, or capital, with the advent of capitalism, tracing this conception back to the 1630s. Cronon explains that because of their European heritage of operating society by a system of property rights, "Colonists were moved to transform the soil by a property system that taught them to treat land as capital . . . Even if a colonist never sold an improved piece of property, the increase in its hypothetical value at market was an important aspect of the accumulation of wealth. These tendencies were apparent as early as the 1630s."[1] Such a concept of stored wealth—in the land or in other so-called commodities—was novel to early North America; Cronon describes how in pre-colonial Amerindian communities, individuals had . . . "little social incentive to accumulate large quantities of material goods [i.e., capital] . . . The same could hardly be said of the European colonists."[2] Although in comparison to their European counterparts, the early American colonies appear far from capitalist societies, in comparison to "their Indian predecessors, they begin to look more like market societies, the seeds of whose capitalist future were already present."[3] In Cronon's view, America was a capitalist society long before de Tocqueville's visit to the nascent nation and even before its formal Independence. The early seeds of capitalism were planted firmly within American soil by the colonists' social construction of land as capital.

But capitalism did not just come over to America as part of the colonists' intellectual heritage; it was a means to survival and thus ultimately a *political* rather than an ideological implant. To continue the metaphor above, the seeds of capitalism may have been carried over on British ships, but they took root only by force of necessity. During the late 16th and early 17th centuries, several settlements in the northeastern US struggled to subsist let alone to grow, because the communal approach to economic production upon which they had been founded failed to produce enough food for their respective communities. It was not until they privatized the lands, giving colonists personal plots to cultivate, that productivity increased and the settlements could sustain themselves. Historian Nathaniel Philbrick describes this transformation towards capitalism as it occurred in the town of Plymouth, Massachusetts:

> The fall of 1623 marked the end of Plymouth's debilitating food shortages. For the last two planting seasons, the Pilgrims had grown crops communally—the approach first used at Jamestown and other English settlements. But as the disastrous harvest of the previous fall had shown, something drastic needed to be done to increase the annual yield. In April, [William] Bradford had decided that each household should be assigned its own plot to cultivate, with the understanding that each family kept whatever it grew. The change in

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[1] William Cronon, *Changes in the Land: Indians, Colonists, and the Ecology of New England* (New York: Hill and Wang, 1983), 77.

[2] Ibid., 166.

[3] Ibid., 76.

> attitude was stunning. Families were now willing to work much harder than they had ever worked before. In previous years, the men had tended the fields while the women tended the children at home. "The women now went willingly into the field," Bradford wrote, "and took their little ones with them to set corn." The Pilgrims had stumbled on the power of capitalism. Although the fortunes of the colony still teetered precariously in the years ahead, the inhabitants never again starved.[4]

Cronon and Philbrick's respective examinations of the history of land ownership in the American colonies together demonstrate how capitalism was able to emerge in thought and then in practice in the early United States, long before any thoughts of becoming a unified, democratic country and long before the visit by a thoughtful Frenchman, with which I begin my own account.

Observations on a Young Democracy: Alexis de Tocqueville

Capitalism has traditionally predated democracy by a century or more, but not in early North America. While capitalism first developed in Europe between 1400 and 1800, Europe could not be said to host a democracy until 1860 in Britain, and still later elsewhere. Writing his *Democracy in America* in the early 1830s, Alexis de Tocqueville identified the United States as the unique democracy of the world, though by today's standards of universal suffrage, the US was not a full democracy until the 1960s, following the enactment and enforcement of its Civil Rights legislation.

De Tocqueville was 25 years old when he departed France, months after the July Revolution of 1830 deposed Charles X and installed Louis-Philippe. The rise of Louis-Philippe brought de Tocqueville, who was raised in an aristocratic family and became a magistrate at the age of twenty-one, into conflict with the new bourgeois regime. He pledged an oath of loyalty and retained his position but maintained qualms about the government, which, in turn, regarded him with suspicion.[5] Ostensibly, de Tocqueville visited America—along with his friend Gustave de Beaumont—on an official French government commission to observe the American prison system. But, as a student of liberalism, de Tocqueville's real aim was to produce a first-hand account of American democracy that might serve as a model for Europe in general and France in particular.[6] His was a highly relevant goal in an age of democratic revolutions: 1830–1831 alone saw revolutions in France, Poland, Belgium, Ireland, and Italy.[7]

Approaching America, de Tocqueville remained attentive to the conditions that allowed democracy to flourish in that republic, which had been forged without the

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[4]Nathaniel Philbrick, *Mayflower: A Story of Courage, Community, and War* (New York: Penguin Press, 2006), 165.

[5]Max Lerner, "Tocqueville in America," in Alexis de Tocqueville, *Democracy in America*, vol. 2 (New York: Harper & Row, 1966), xxviii.

[6]Phillips Bradley, Introduction to Alexis de Tocqueville, *Democracy in America*, vol. 1 (New York: Alfred Knopf, 1953), pp. ix–xii.

[7]Lerner, "Tocquevillle in America," xxviii.

burden of a feudal past or a bloody social revolution.[8] He considered the structure and philosophy that secured America's democracy, while noting internal and external threats to its maintenance. A thorough and scholarly work, his *Democracy in America* has been called "not only the greatest book ever written on America, but probably the greatest on any national polity and culture."[9] It retains its relevance today, offering "shrewd glimpses"[10] of Jacksonian America while revealing conditions that have persisted as permanent fixtures on the American scene.

De Tocqueville identified property ownership as a cornerstone of stability in the American democratic system; this stability was guaranteed by a middle class with "enough property to want order."[11] Widespread property ownership served as both a basis and anchor of democracy, rendering revolutions undesirable because "Any revolution is more or less a threat to property. Most inhabitants of a democracy have property. And not only have they got property, but they live in the conditions in which men attach most value to property."[12] He observed: "Almost every revolution which has changed the shape of nations has been made to consolidate or destroy inequality ... if you could establish a state of society in which each man had something to keep and little to snatch, you would have done much for the peace of the world."[13]

Seemingly, liberty and property went hand-in-hand in the United States, where property-owning citizens cooperated to ensure their common interest. De Tocqueville commented: "Americans regard[ed] their freedom as the best tool of and the firmest guarantee for their prosperity. They love them both for the sake of each other ... they think it their most important concern to secure a government which will allow them to get the good things they want and which will not stop their enjoying those they have in peace."[14] De Tocqueville conjectured that Americans pursued democratic egalitarianism and personal material gain with equal gusto: "An American will attend to his private interests as if he were alone in the world; the moment afterward, he will be deep in public business as if he had forgotten his own."[15] The paradox of the ardent pursuit of these potentially divergent goals was resolved, de Tocqueville continued, in the holistic achievement of American society itself, which "united and mingled" impulses towards material gain and public service.[16] In de Tocqueville's scheme, democratic participation secured the freedoms that buttressed American capitalism and property ownership.

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[8]Tocqueville commented at length on the relationship between equality and capitalism, a topic taken up later in this case.

[9]Lerner, "Tocquevillle in America," xxv.

[10]Bradley, Introduction, xix.

[11]Tocqueville, *Democracy in America*, 2:611.

[12]Ibid.

[13]Ibid.

[14]Ibid., 513.

[15]Ibid.

[16]Ibid.

The American government that de Tocqueville encountered was peculiar: a democracy rooted in local governance and paired with a relatively small and weak central administration. De Tocqueville quipped: "The people reign in the American political world as the Deity does in the universe. They are the cause and aim of all things; everything comes from them, and everything is absorbed in them."[17] Popular will was exercised locally in townships, a system typified by the New England experience, where nineteen independent American magistrates might perform the job of a single French *maire.*[18] The administration in these townships had no direct link to federal or even state administration; courts served as instruments whereby the central government might intervene.[19] Strong popular governance encountered a "feeble" and "restricted" central administration.[20] The American President corralled only a small fraction of the authority of the French king: the French population hovered around 150% that of America, but the king had license to appoint 138,000 public functionaries, while the president's nominations were restricted to around 12,000.[21,22]

Ultimately, de Tocqueville, in attempting to carefully describe the government, was surprised at its seeming invisibility. He wrote:

> Nothing is more striking to a European traveler in the United States than the absence of what we term the government, or the administration. Written laws exist in America, and one sees the daily execution of them; but although everything moves regularly, the mover can nowhere be discovered. The hand that directs the social machine is invisible. . . . No idea was ever entertained of attacking the principle or contesting the rights of society; but the exercise of its authority was divided, in order that the office might be powerful and the officer insignificant, and that the community should be at once regulated and free. In no country in the world does the law hold so absolute a language as in America; and in no country is the right of applying it vested in so many hands. The administrative power in the United States presents nothing either centralized or hierarchical in its constitution; this accounts for its passing unperceived. The power exists, but its representative is nowhere to be seen.[23]

In the absence of strong central authority, how did the interests of personal autonomy and public service arise and align in America? How could they both be highly decentralized at the same time; and was this a stable relationship or one that was transitory? Considering "how democracy favors the development of industry," de Tocqueville had warned: "industry may in turn lead men back to aristocracy."[24]

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[17] Alexis de Tocqueville, *Democracy in America*, vol. 1 (New York: Alfred Knopf, 1953), 58.

[18] Ibid., 72.

[19] Ibid., 74.

[20] Ibid., 57.

[21] "It results from this comparison that the King of France has eleven times as many places at his disposal as the President, although the population of France is not much more than one and one-half times that of the Union." See Ibid., 125.

[22] Ibid .

[23] Ibid., 70–71.

[24] Tocqueville, *Democracy in America*, 2:528.

What links, if any, existed between capitalism and aristocracy, and how might this affect the future development of the United States?

A Natural Experiment in Colonial Settlement

As the previous chapter on Latin America discussed, European settlers to the New World were part of a "natural experiment."[25] While the land that they discovered was inhabited by Amerindians who might normally have repulsed their incursion, the latter were decimated by European pathogens far more than European arms.[26] Faced with a "blank slate," land that was only lightly populated or defended, settlers took it upon themselves to impose order and governance. Consequently, a wide variety of institutions arose, chiefly in accordance with initial factor endowments. The rich land in the southern colonies of British North America, suitable for plantation agriculture, invited forced labor and led to greater inequality than in the northern British colonies, where poorer soil supported mixed farming for local markets.[27] Cultural precedent also contributed to the variations in these new institutions: French settlers in present-day Canada founded colonies that differed substantially from adjacent British settlements.[28] Table 7.1 provides data demonstrating how different regions in the New World with different factor endowments gave rise to different institutions and ultimately different levels of economic success, as measured by GDP per capita.

Along with factor endowments, economic conditions such as inequality affect institutional development, and these resulting institutions, in many instances, subsequently perpetuate inequality. Education is a prime example of this self-reinforcing trend. In the New World, the United States and Canada set a high standard in primary schooling and literacy, and the Iberian colonies—as well as the British colonies in the Caribbean, which didn't promote schooling until the 1870s—trailed behind. The discrepancies in investment in education between the Northern Atlantic colonies

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[25] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 2.

[26] Charles C. Mann, *1491: New Revelations of the Americas before Columbus* (New York: Knopf, 2005).

[27] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 34.

[28] The economists Stanley Engerman and Kenneth Sokoloff argue that factor endowments had a profound influence on the development of early institutions and led to differing forms of governance, which in turn influenced the economic fortunes of countries in the Americas. This argument explains how and why different institutions arose within the British North American colonies: south of the Chesapeake, where factor endowments were rich and cash-cropping quickly took hold, imported English institutions supported slavery and concentrations of wealth. In the northern colonies, British institutions took root in very different soil and produced very different results. See Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*.

Table 7.1 The record of gross domestic product per capita in selected New World economies relative to the United States

	1700	1800	1900	1997
Argentina	–	102	52	35
Barbados	150	–	–	51
Brazil	–	50	10	22
Chile	–	46	38	42
Cuba	167	112	–	8
Mexico	89	50	35	28
Peru	–	41	20	15
Canada	–	–	67	76
United States (GDP p.c. in 1985$)	550	807	3,859	20,230

Source: Compiled from Kenneth L. Sokoloff and Stanley L. Engerman, "History Lessons: Institutions, Factor Endowments, and Paths of Development in the New World," *The Journal of Economic Perspectives* 14 (Summer, 2000): 219; OECD (2001), The World Economy: A Millennial Perspective, www.theworldeconomy.org

and Latin America cannot be explained as arising from differences in cultural heritage, religion, or even income. Rather, prominent economists have attributed the early encouragement of education in the United States and Canada to economic and political equality and ethnic homogeneity.[29] Conversely, the promotion of education in Latin America stalled because of inequality.

French North America: Establishing Trading Posts

Permanent European settlement in North America began with the 1607 British founding of Jamestown by the London Company[30], followed by the 1608 founding of French Quebec.[31] The area that makes up modern-day Canada was occupied jointly, in parts, by the British and the French. The French maintained control over land that today constitutes the Maritime Provinces (Prince Edward Island, Nova Scotia, and New Brunswick), and both Britain and France laid claim to Newfoundland. This arrangement persisted until 1713, when control of the Atlantic colonies passed to Britain

[29] Mariscal and Sokoloff, "Schooling, Suffrage, and the Persistence of Inequality in the Americas, 1800–1945," 170.

[30] The London Company, a "crown-chartered joint-stock company with monopoly trading rights" was later renamed the Virginia Company. See Jeremy Atack and Peter Passell, *A New Economic View of American History, from Colonial Times to 1940*, 2nd ed. (New York: W. W. Norton, 1994), 29.

[31] Englishman Sir Walter Raleigh established the outpost of Roanoke Island off of North Carolina in 1584, but the colony failed and its settlers mysteriously disappeared. See Atack and Passell, *A New Economic View of American History, from Colonial Times to 1940*, 29.

under the Treaty of Utrecht[32], leaving France with Cape Breton and Prince Edward Island while New Brunswick remained in dispute.[33] France later withdrew entirely from Canada, except for the tiny islands of St. Pierre and Miquelon, under the terms of the Treaty of Paris in 1763.[34]

French interest in Canada was motivated more by economic opportunity than by the desire for colonial settlement. Fish and fur functioned as valuable resources in northern North America, and Europeans were eager to exploit this northern bounty.[35] New France initially amounted to "little more than a trading post—a tiny extension of the Old World's commercial and religious interests to the New World."[36] In 1660, the settling of New France remained tentative, with fewer than three thousand Europeans in place; one historian notes: "'There was the constant feeling that at any moment everyone might pack up and go back to France.'"[37] Table 7.2 shows the relatively scant population established in Canada and elsewhere in this period. Settlement was facilitated by private companies[38] until 1663, when New France became a royal colony.[39]

After 1663, landholding and farming surfaced as increasingly important activities in settlements along the St. Lawrence. Unlike British settlements to the south, where colonies' boundaries conformed to the line of agricultural settlement, New France constituted a "'river empire,' with long tentacles of economic, political, and military influence stretching thousands of miles beyond the area of settlement" along the St. Lawrence River, through the Great Lakes, and eventually down the Mississippi and out to the Rocky Mountains.[40]

New France borrowed its system of land title from France, relying on the seigneurial system, a feudal tradition in which the crown granted land to *seigneurs*, who were, in turn, responsible for the *censitaires* or *habitants* who farmed the land and owed allegiance and duties.[41] While the feudal landholding system was imported from France, the commodities of land and labor differed substantially, since New France was significantly less hierarchical than France. Seigneurs in New France had less power and wealth than their French counterparts, and they were faced with the difficulty of attracting habitants to make their land productive.[42] New France developed as a "long, thin ribbon of population" along

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[32]Kenneth Norrie and Douglas Owram, *History of the Canadian Economy* (Toronto: Harcourt Brace & Company, Canada, 1996), 26.

[33]Ibid., 38.

[34]Ibid., 11.

[35]Ibid.

[36]Ibid., 41.

[37]Marcel Trudel, *The Beginnings of New France, 1524–1663* (Toronto: McClelland & Stewart, 1973), 270, quoted in Norrie and Owram, *History of the Canadian Economy*, 47.

[38]Norrie and Owram, *History of the Canadian Economy*, 46.

[39]Ibid., 48.

[40]Ibid., 44.

[41]Ibid., 50.

[42]Ibid., 53.

Table 7.2 Population c. 1660–1870 (in thousands)

	c. 1660	c. 1730	c. 1760	c. 1790	c. 1810	c. 1830	c. 1850	c. 1870
United States	100		1,594	3,929	7,240	12,866	23,192	39,818
Canada	3	34	65				2,436 (1851)	3,689 (1871)
Australia							438 (1851)	1663 (1870/1)
New Zealand							27 (1851)	256 (1871)
France			25,246	27,349 (1801)	29,106 (1806)	32,569 (1831)	35,783 (1851)	36,103 (1872)
England & Wales				8,893 (1801)	10,164 (1811)	13,897 (1831)	17,928 (1851)	22,712 (1871)
Scotland				1,608 (1801)	1,806 (1811)	2,364 (1831)	2,889 (1851)	3,360 (1871)
Argentina								1737 (1869)
Brazil							7,678 (1854)	9,930 (1872)
Chile						1,111 (1835)	1,516 (1854)	1,819 (1865)
Peru				1,232 (1795)		1,374 (1836)	2,001	
India								20,3415 (1867–1872)

Source: Compiled from B. R. Mitchell, *International Historical Statistics: The Americas, 1750–2000*, 5th ed. (New York: Palgrave Macmillan, 2003); *International Historical Statistics: Africa, Asia and Oceania*, 4th ed. (New York: Palgrave Macmillan, 2003); *International Historical Statistics: Europe, 1750–2000*, 5th ed. (New York: Palgrave Macmillan, 2003); F. Henry Johnson, *A Brief History of Canadian Education* (Toronto: McGraw-Hill, 1968), p. 7; Kenneth Norrie and Douglas Owram, *History of the Canadian Economy* (Toronto: Harcourt Brace & Company, Canada: 1996), p. 47; David Moss, "Constructing a Nation: The United States and Their Constitution, 1763–1792," Harvard Business School Case No. 795-063 (Boston: Harvard Business School Publishing, 1996), p. 12, Exhibit 2, adapted from Angus Maddison, *Dynamic Forces in Capitalist Development* (New York: Oxford University Press, 1991), pp. 226–227; Jeremy Atack and Peter Passell, *A New Economic View of American History, from Colonial Times to 1940*, 2nd ed. (New York: W. W. Norton, 1994), p. 3

the St. Lawrence, eschewing previous conventions of villages and community centers distinct from countryside.[43] The French feudal landholding system was thereby adapted somewhat incongruously in the setting of New France, with its abundant land, scarce, relatively egalitarian population, and geographically-rational settlement patterns along rivers. Figure 7.1 illustrates a sample seigneurial settlement pattern.

[43]Ibid., 50.

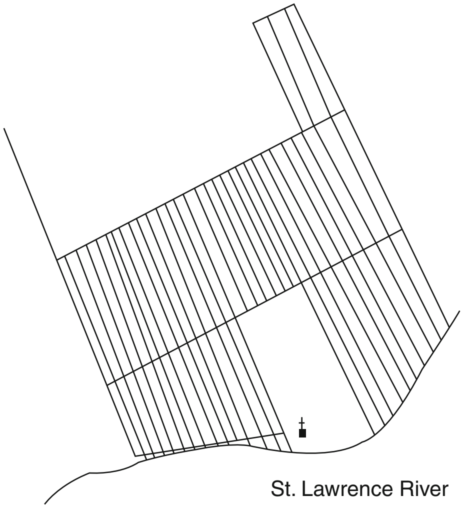

Fig. 7.1 Settlement pattern in a hypothetical seigneurie, New France. Source: Adapted from Richard Colebrook Harris, *The Seigneurial System in Early Canada: A Geographical Study*, 2nd ed. (Montreal: McGill-Queen's University Press, 1984), 175, Figure 9-1

Officially, the seigneurial system remained intact with the British assumption of political control; freehold tenure was not established for new lands until 1791, and the seigneurial divisions stayed in place until 1854.[44] In practice, however, land tenure became an increasingly complicated issue with the extension of British control over New France in 1713 and 1763 and the arrival of Loyalists fleeing the American Revolution to the south. What ensued was a confusion in which British settlers in Canada followed unofficial policies of freehold land tenure, despite the presumption of a seigneurial system. The Constitutional Act of 1791 split the region of Quebec into Lower and Upper Canada, with Lower Canada persisting as the eastern segment occupied by French-speaking Roman Catholics, while Upper Canada was dominated by English-speaking Protestants. Thereafter, Upper Canada abolished the seigneurial system and eventually implemented a system to grant clear titles to land.[45]

British North America: Establishing a Quasi-autonomous Capitalist System

British colonization of North America took place comparatively late; one historian notes: "As the first permanent English settlers in North America set about chopping down trees to make crude cabins in December of 1620, the Spanish and Portuguese

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[44] Ibid., 97–98.
[45] Ibid., 119–120.

empires in the New World had already passed their first century."[46] The British colonies north of the Chesapeake were founded by charter at different times with different purposes, and initially as poor cousins to the wealthy colonies in the South. These northern colonies boasted abundant but relatively unattractive land, unsuitable for plantation agriculture, lacking in minerals, and without an exploitable native population.

For the first 150 years of New England settlement, the net migration rates were actually negative.[47] Population growth occurred through natural increase, as demonstrated in Table 7.3, which shows patterns of net migration to British colonies. The challenge for these colonies was to draw settlers in order to build local markets. Democratic political values in the northern colonies developed in part to appeal to and entice European immigrants to the New World. To attract colonists, these colonies promised free land, religious freedom, civil liberties and rights, jury trials, and equality before the law.[48] Indeed, beyond attracting settlers, the private cultivation of plots—which replaced communal planting in Plymouth in 1623—also yielded a "stunning" shift in attitude and signaled the end of food shortages in that settlement, as communal division of labor ended and whole families devoted themselves to the enterprise of raising crops.[49] The ratio of labor-to-land remained low, despite the successful settlement of the coastal and river regions. The frontier drew younger and poorer colonists westward so that the New England population density increased slowly.[50] The combination of high rates of property ownership, high wages, and respect for civil liberties and religious freedoms ensured that town and colonial governments retained their basic egalitarian character.[51]

Some British institutions did not survive in the northern colonies, and new institutions had to be invented. Land markets and contracts developed very differently in the north than in other British colonies. The Crown enforced *free and common socage*, which came to be known as *fee simple*. A departure from the English feudal system of tenure and its concomitant web of obligations, the fee simple system provided that land be owned and sold, used and unused, without any impediment to that

[46]Coatsworth, "Economic and Institutional Trajectories in Nineteenth-Century Latin America," 24.

[47]Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 17.

[48]John M. Murrin et al., *Liberty, Equality, Power: A History of the American People*, 3rd ed. (United States: Wadsworth/Thomson Learning, 2002), 78.

[49]Philbrick, *Mayflower*, 165.

[50]Stanley L. Engerman and Kenneth L. Sokoloff, "History Lessons: Institutions, Factor Endowments, and Paths of Development in the New World," *Journal of Economic Perspectives* 14 (Summer 2000): 223.

[51]Douglass C. North, Terry L. Anderson, and Peter J. Hill, *Growth and Welfare in the American Past: A New Economic History* (Englewood Cliffs, NJ: Prentice Hall, 1983), 50; Murrin et al., *Liberty, Equality, Power: A History of the American People*, 149.

Table 7.3 Patterns of net migration to categories of British colonies

	Destination of migrants							
	New England in thousands	row %	Middle Atlantic in thousands	row %	Southern in thousands	row %	West Indies in thousands	row %
Whites								
1630–1680	28	11.0	4	1.6	81	31.9	141	55.4
1680–1730	−4	−1.8	45	19.9	111	49.1	74	32.7
1730–1780	−27	−10.7	101	40.1	136	54.0	42	16.7
Total, 1630–1780	−3	−0.4	150	20.5	328	44.28	257	35.1
Blacks								
1650–1680	0	–	0	–	5	3.7	130	96.3
1680–1730	2	0.5	5	0.9	64	12.0	461	86.7
1730–1750	−6	−0.9	−1	−0.2	150	23.4	497	77.7
Total, 1630–1780	−4	−0.3	4	0.3	219	16.8	1088	83.2
Total								
1630–1680	28	7.2	4	1.0	86	22.1	271	69.7
1680–1730	−2	−0.3	50	6.6	175	23.1	535	70.6
1730–1750	−33	−3.7	100	11.2	286	32.1	539	60.4
Total, 1630–1780	−7	−0.3	154	76	547	26.8	1345	66.0

Source: Stanley L. Engerman and Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, NBER Working Paper No. 9259 (Cambridge: National Bureau of Economic Research, 2002), 45, Table 2 absolute ownership except the payment of quit rents, or property taxes.[52] Mineral rights could be reserved by the seller—or donor—rather than passing wholly to the buyer.[53]

British sea power protected the colonies from external threat, and they encountered little internal threat in the form of entrenched native populations that might have prompted the formation of centralized systems.[54] The British Crown that chartered the North American colonies sought to reap as much profit from them as possible, shifting much of the expense to the colonists themselves. The charters all provided for local self-rule and self-maintenance. Only the royal governor of each colony directly connected each colony with England. Despite the comparative poverty of the climate and soil in the north,[55] standards of living in America were at least as high as those in England.[56] In fact, the disposable incomes of the colonists were among the highest in the world by the early 1770s, owing to low taxes in the colonies.[57]

In this isolation, colonists adapted English Tudor forms of local rule which were based on small, local, relatively democratic, and frugal government.[58] The laws and taxation policies of these early legislatures tended to work for local interest and egalitarian principles and against royal or hierarchical interests. From the beginning, American colonists controlled the methods of collection and application of their own taxes. The colonial legislatures levied taxes, managed their treasuries, and kept the royal governors on tight budgets. As in England, local governments were responsible for the care of the poor, sick, and insane. In northernmost colonies,

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[52] Hughes and Cain outline the "main distinguishing characteristics of free and common socage": "(1) It was perpetual (not limited to any term of years); (2) It was directly heritable by heirs (it did not need to be regranted by the donor); (3) It could be passed by will; (4) All the obligations on it had to be 'fixed and certain'; (5) The right of waste [i.e., the right to abuse the land] existed fully; (6) Socage land was freely *alienable* (it could be sold) by its owner." See Jonathan Hughes and Louis P. Cain, *American Economic History*, 6th ed. (Boston: Addison Wesley, 2003), 15.

[53] Hughes and Cain, *American Economic History*, 13–16.

[54] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 14.

[55] Murrin et al., *Liberty, Equality, Power: A History of the American People*, 68–80; Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986), 363–365.

[56] Hughes and Cain, *American Economic History*, 49.

[57] Ibid.

[58] Huntington, *Political Order in Changing Societies*, 96.

town councils often added to their list of responsibilities the provision for common schools.[59,60] The colonial budgets were too small to provide for an elaborate hierarchy of judges and royal authorities, and the British crown was unwilling to pay to support a top-heavy colonial administration until the mid-18th century.[61]

The colonies south of the Chesapeake, which would constitute the southern United States, possessed richer factor endowments and thus offered the opportunity to develop economies of scale with plantation agriculture, such as tobacco and rice crops, through the use of slave labor. As the northern colonies struggled to attract immigrants, migrants were drawn to the southern colonies, with their higher per capita output.[62] Table 7.4 demonstrates the greater wealth to be had in the southern colonies of America at the time.

Southern institutions developed in accordance with their economy. While the northernmost colonies levied direct taxes on property, the colonies around the

Table 7.4 Private wealth per capita in 1774

	New England	Middle colonies	South	Thirteen colonies
Land	£26.1	£25.9	£25.1	£25.6
Livestock	2.8	4.8	4.8	4.3
Equipment	1.7	1.7	1.5	1.6
Inventories	1.5	3.9	1.8	2.3
Consumers' goods	4.4	4	3.1	3.7
Slaves	0.2	1.6	18.4	9.1
Total	£36.6	£41.9	£54.7	£46.5

Source: Alice Hanson Jones, *Wealth of a Nation to Be* (New York: Columbia University Press, 1980), 96, Table 4.2

[59] Historian Bernard Bailyn describes the early difficulties encountered with school funding, when sources of support "were found only in direct and repeated contributions by the community. There was, at first, not only an understandable reluctance to venture beyond the familiar forms of financing but also considerable confusion as to what procedures were proper once such steps were contemplated. In Massachusetts, for example, the pledge of community property for education became common only after laws were passed compelling individuals of supposed wealth to volunteer more generously; and when it was apparent that not even the grant of common town land would be sufficient and that direct taxation would have to be resorted to, the yield from school rates most often was considered to be only temporary supplements to the more familiar endowments and tuition payments." See Bernard Bailyn, *Education in the Forming of American Society: Needs and Opportunities for Study* (Chapel Hill: Published for the Institute of Early American History and Culture at Williamsburg, Va., by the University of North Carolina Press, 1960), 43–44.

[60] Webber and Wildavsky, *A History of Taxation and Expenditure in the Western World*, 363–364; Hughes and Cain, *American Economic History*, 40–41; North et al., *Growth and Welfare in the American Past: A New Economic History*, 53.

[61] Webber and Wildavsky, *A History of Taxation and Expenditure in the Western World*, 363.

[62] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 14–15.

Chesapeake employed a system of direct and indirect taxation and a graduated poll tax that targeted elites.[63] The colonies in the North maintained a relatively egalitarian political system flowing from egalitarian income distribution,[64] and the South

[63] Webber and Wildavsky, *A History of Taxation and Expenditure in the Western World*, 363–364; North et al., *Growth and Welfare in the American Past: A New Economic History*, 53.

[64] A note on American egalitarianism:

The precise nature of egalitarianism in the American colonies remains a subject of some debate among modern historians. Edward Pessen, disputing Tocqueville's "portrait" of economic and social equality in America, writes that, in antebellum America, "the great majority of the population were working people or small farmers who held little of the nation's wealth." In attempting to prove Tocqueville wrong, Pessen focuses on four American cities—New York, Boston, Philadelphia, and Brooklyn—that contain approximately 4% of the nation's population. He locates "substantial fortunes" in these cities, alongside considerable poverty.

In her landmark study, *Wealth of a Nation to Be: The American Colonies on the Eve of the Revolution*, Alice Hanson Jones examines probate records from 1774 and concludes that the levels of inequality in the colonies "though high, was probably not so great as that in England three quarters of a century earlier." She describes the American colonists as "relatively well off in comparison with the bulk of the population in Europe of that day and in comparison with much of the world's population in today's lesser developed countries."

Jeffrey Williamson and Peter Lindert offer an overview of the literature on American inequality and emphasize the importance of considering *trends* in wealth inequality rather than merely levels of inequality. They defend the claim that "trends were mixed but in the aggregate colonial inequality was stable at low levels" and consider potential biases of urban revisionism, tax data, and even the compositional fallacy of selecting proper benchmark dates. In attempting to isolate factors that might distort data on inequality, they hypothesize that "[i]t seems likely that the South, rather than northern towns, offered the largest contributions to rising aggregate inequality before the Revolution." Williamson and Lindert identify several potential failings of Hanson Jones's work, including her relatively small sample size (only 919 observations) and use of probate records, which were likely to incur the widespread exclusion of the very poor in the colonies, a group least likely to leave inventory behind at their deaths. Conceding that Hanson Jones's approach "might have led to a serious underestimation of wealth inequality in 1774," they reiterate no indication of "clear bias in the estimates" and conclude that although "the colonial era was one of relative egalitarianism and stable wealth distribution, it was followed by an episode of rising wealth concentration lasting for more than a century." In a 1994 article, R. V. Jackson re-emphasizes the many complications involved when computing historical inequality and notes the importance of considering mortality data alongside income and wealth in order to better appreciate the "inequality implications of mortality trends."

Despite the many factors that demand consideration when computing comparative historical levels of inequality, most authors concur that inequality in early American was, in aggregate, lower than found in Europe. Williamson and Lindert note: "Visiting contemporary observers were unanimous in describing colonial America as a utopian middle-class democracy, where economic opportunities were abundant and egalitarian distributions the rule." While America may have failed to live up to the level of egalitarianism extolled by foreign visitors, it is useful to recall, as Williamson and Lindert have, that these visitors "thought America was egalitarian by European standards." [See Edward Pessen, *Riches, Class, and Power: America Before the Civil War* (New Brunswick: Transaction Publishers, 1990); Alice Hanson Jones, *Wealth of a Nation to Be: The American Colonies on the Eve of the Revolution* (New York: Columbia University Press, 1980); Jeffrey G. Williamson and Peter H. Lindert, *American Inequality: A Macroeconomic History* (New York: Academic Press, 1980).]

Table 7.5 Physical wealth of free wealth holders in colonial North America in 1774

	New England	Middle Colonies	South	All Thirteen Colonies
Average physical wealth	£161.2	£189.2	£394.7	£252.0
of gentlemen	313.4	1,233.0	1,281.3	572.4
of merchants	563.1	858.0	314.0	497.1
of farmers				
with ancillary income	144.2	257.3	801.7	410.5
without outside income	155.3	179.8	396.1	262.3
of professionals	270.6	240.6	512.2	341.0
of artisans	114.5	144.5	137.8	122.5
Distribution of wealth				
Bottom 20%	1.0%	1.2%	0.7%	0.8%
Top 20%	65.9%	52.7%	69.6%	67.3%

Source: Compiled from Jeremy Atack and Peter Passell, *A New Economic View of American History*, 2nd ed. (New York: W. W. Norton, 1994), 51, Table 2.7; Edwin J. Perkins, *The Economy of Colonial America*, 2nd ed. (New York: Columbia University Press, 1988), 219, 223; and Alice Hanson Jones, *Wealth of a Nation to Be* (New York: Arno Press, 1978), Table 7.5

"lagged behind the North ... in evolving a set of political institutions that were conducive to broad participation in the commercial economy."[65] Table 7.5 shows such a contrast in the distribution of wealth among the American colonies.

The presumed authority of the colonial local government was threatened by the wars between the British and the French from 1730 to 1763. The British mounted a real, global militarization against the French in Canada and the northern colonies. The wars demanded the garrisoning and supplying of extensive professional British troops and their suppliers and administrators. The costs and stakes were high, and the British crown levied the Stamp Tax and Tea Tax on the North American colonies, while also enforcing the Trade and Navigation Treaty to channel tax revenues to the royal colonial administration and the British army. While the crown expected that the colonists should bankroll their defense, the colonists chafed at the arbitrary imposition of royal authority on their established practices of self-government and taxation. The American Revolution's hallmark of "no taxation without representation," while radical in outcome, was fundamentally conservative, a defense of the colonial tradition of local self-rule and taxation.[66]

[65] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 15.

[66] Webber and Wildavsky, *A History of Taxation and Expenditure in the Western World*, 365; North et al., *Growth and Welfare in the American Past: A New Economic History*, 51; Huntington, *Political Order in Changing Societies*, 98.

As the northern American colonies embarked on their declaration of a state distinct from England, they built further upon their established egalitarian foundations. American historian Richard Hofstadter illustrates the reaction of J. Hector St. John de Crèvecœur, the French-aristocrat-turned-Hudson-Valley-farmer and author of *Letters from an American Farmer*:

> In the very hours of its birth as a nation Crèvecœur had congratulated America for having, in effect, no feudal past and no industrial present, for having no royal, aristocratic, ecclesiastical, or monarchical power, and no manufacturing class, and had rapturously concluded: "We are the most perfect society now existing in the world." Here was the irony from which the farmer suffered above all others: the United States was the only country in the world that began with perfection and aspired to progress.[67]

Governing a New Nation

> *In today's world, American political institutions are unique, if only because they are so antique.*[68]
>
> —Samuel Huntington

The political scientist Samuel Huntington has written that the political institutions that took root in colonial America were not modernized European systems, but rather "essentially Tudor and hence significantly medieval in character," relying on 16th century British political approaches.[69] In America, the Tudor influence contributed to, among other things, a division of power, a dissolution of central authority or active sovereignty, and a divided legislature system.[70] While Britain itself experienced a centralization of power under the Stuarts, America persisted with and built upon its early importation of Tudor traditions.[71] America inherited the authoritative positioning of law—and government's subordination to law—from the Tudors.[72] Huntington notes: "The sovereignty of law permitted a multiplicity of human authorities, since no single human authority was the sole source of law."[73] This notion of fundamental law was subsequently codified and preserved in America's Federal Constitution in 1787.[74]

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67 Richard Hofstadter, *The Age of Reform: From Bryan to F.D.R.* (New York: Vintage Books, 1955), 35–36.

68 Huntington, *Political Order in Changing Societies*, 98.

69 Ibid., 96.

70 Ibid., 93–139.

71 Ibid., 96–98.

72 Ibid., 98–99.

73 Ibid., 100.

74 Ibid., 104.

The Confederation, 1777–1787

In the midst of conflict with Great Britain, representatives from the colonies met at a Continental Congress in 1774. The Congress called for a boycott of British goods and issued a Declaration of American Rights, iterating the rights that Americans should hold as English citizens and determining colonial authority over internal issues. Congress asserted that the colonies, as distinct realms, were subject to the English crown but not to Parliament. In response to Congress's declarations, English Parliament refused compromise. By late 1774, colonial militias were readying themselves for confrontation, and in 1775 the American Revolution began in earnest.[75]

As David Moss details in his 1996 case, "Constructing a Nation: The United States and Their Constitution, 1763–1792," the Articles of Confederation, adopted by the Continental Congress in 1777 and ratified in 1781, provided for a weak central governing body, lacking a presidency or judiciary.[76] The Articles of Confederation vested the Congress, composed of a single representative from each state, elected yearly, with the power to declare war, make treaties and alliances, settle disputes between states, and borrow. Congress had further authority over postal service, Indian affairs, and governance of the western territories. It lacked, however, the power to impose direct taxes, regulate foreign or domestic commerce, and enforce its resolutions or ordinances.[77] States retained power over taxation and commerce. The Articles of Confederation would remain in effect after the British surrender that ended the Revolutionary War in 1783, persisting until the ratification of the Federal Constitution in 1788.[78]

Land Policy

Throughout the Americas, where agriculture prevailed, land policy had profound implications for the distribution of wealth.[79] In the thirteen colonies, land ownership was readily accessible: in 1774, nearly three out of every four free families owned land.[80] This figure would remain high relative to the Latin American colonies

[75] George Brown Tindall and David E. Shi, *America: A Narrative History*, 4th ed. (New York: W.W. Norton & Company, 1996), 222–226.

[76] David A. Moss, *Constructing a Nation: The United States and Their Constitution, 1763–1792*, Harvard Business School Case (Boston: Harvard Business School Publishing, 1996).

[77] Tindall and Shi, *America: A Narrative History*, 268.

[78] Moss, *Constructing a Nation: The United States and Their Constitution, 1763–1792*.

[79] Stanley L. Engerman and Kenneth L. Sokoloff, *Colonialism, Inequality, and Long-Run Paths of Development*, NBER Working Paper No. 11057 (Cambridge: National Bureau of Economic Research, January 2005), 18–19.

[80] Stanley Lebergott, "The Demand for Land: The United States, 1820–1860," *Journal of Economic History* 45, no. 2 (June 1985): 184.

Table 7.6 The number of households owning land was much higher in US and Canada than in Mexico and Argentina

	Percentage of household heads who own land
Total Rural Mexico, 1910	2.4
Argentina, 1895	19.2
Total United States, 1900	74.5
Total Canada, 1901	87.1

Source: Adapted from Engerman and Sokoloff, *Colonialism, Inequality, and Long-Run Paths of Development,* NBER Working Paper 11057 (Cambridge: National Bureau of Economic Research, January 2005), Table 4

throughout the coming centuries, as suggested by the limited comparison of land ownership in the US and its neighbor, Canada, with that of two Latin American countries in Table 7.6. Wealth concentrated in landholdings constituted the largest segment of overall per capita wealth, as Table 7.4 attests. Early American statesmen were highly attuned to the effects that wealth distribution and property ownership might have on the nascent republic.

John Adams, voicing the potential positive influence of widespread property ownership, claimed that it could create and secure true citizens by preventing men from falling prey to the interests of those who bought their labor. It was through property ownership, Adams believed, that every man might claim a stake in government and inure himself against poverty. He wrote in 1776:

> Harrington has shown that power always follows property. This I believe to be as infallible a maxim in politics, as that action and reaction are equal, is in mechanics. Nay, I believe we may advance one step farther, and affirm that the balance of power in a society, accompanies the balance of property in land. The only possible way, then, of preserving the balance of power on the side of equal liberty and public virtue, is to make the acquisition of land easy to every member of society; to make a division of the land into small quantities, so that the multitude may be possessed of landed estates. If the multitude is possessed of the balance of real estate, the multitude will have the balance of power, and in that case the multitude will take care of the liberty, virtue, and interest of the multitude, in all acts of government. I believe these principles have been felt, if not understood, in the Massachusetts Bay, from the beginning; and therefore I should think that wisdom and policy would dictate in these times to be very cautious of making alterations.[81]

Once the colonies achieved independence, the national government inherited a strategic and structural problem that had plagued the British crown: the settlement and governance of the region that had been transferred from France to Britain in 1763 and claimed by the US after the 1783 Treaty of Paris ending the American Revolution, i.e., the frontier. The frontier—with all its promise of free and abundant

[81] John Adams to James Sullivan, 26 May 1776, in John Adams, *The Works of John Adams*, ed. Charles Francis Adams (Boston, 1850), 376–377.

land—was ever-expanding and being settled by unruly frontiersmen who threatened the security of the fledgling Confederation by infringing on Indian and French territories.[82] In 1783, at the request of George Washington, Thomas Jefferson[83] led a committee to present a report and plan on how to confront the issue of the frontier.[84]

The first land ordinances gave physical shape to the economic and legal foundations for republican government in the western fringes of the confederation, providing for a "lateral expansion of American democracy."[85] Jefferson's Ordinance of 1784 was approved by Congress but never implemented in full. Instead, his insistence on fee simple property rights and the principles of self-government were preserved in the re-worked Land Ordinance of 1785,[86] which established a grid system of six square mile townships carved into thirty-six 640-acre sections, based on New England, as Fig. 7.2 maps out. The 1785 Ordinance included a provision to set aside a section of land in each township for the support of a public school.

– **6**	– **5**	– **4**	– **3**	– **2**	– **1**	–
– **7**	– **8**	– **9**	– **10**	– **11**	– **12**	–
– **18**	– **17**	– **16***	– **15**	– **14**	– **13**	–
– **19**	– **20**	– **21**	– **22**	– **23**	– **24**	–
– **30**	– **29**	– **28**	– **27**	– **26**	– **25**	–
– **31**	– **32**	– **33**	– **34**	– **35**	– **36**	Note: Section 16 was reserved for schools.

Fig. 7.2 Sections of a township under the Northwest Ordinance (36 square miles total), United States. Source: Jonathan Hughes and Louis P. Cain, *American Economic History*, 6th ed. (Boston: Addison Wesley, 2003), 92, Figure 5.1

[82] Murrin et al., Liberty, Equality, Power: A History of the American People, 243.

[83] Though Thomas Jefferson had left months before the Ordinance of 1785 was discussed or enacted for a five year diplomatic post in Paris, his thoughts on property rights and the size of the townships seems to have been taken into consideration. His plan that the townships be ten miles square was modified in the Ordinance of 1785 to the New England custom of six square miles. See Joseph J. Ellis,*Founding Brothers: The Revolutionary Generation* (New York: Knopf, 2000) for a description of Jefferson's disengagement from American politics between 1784 and 1789. Some historians have called into question Jefferson's real influence on the Ordinances of 1785 and 1787.

[84] Robert F. Berkhofer, Jr., "Jefferson, the Ordinance of 1784, and the Origins of the American Territorial System,"*The William and Mary Quarterly* 29 (April 1972): 237–248.

[85] Hughes and Cain, *American Economic History*, 91.

[86] Hughes and Cain, *American Economic History*, 88–89; *Liberty's Legacy: Our Celebration of the Northwest Ordinance and the United States' Constitution*, ed. Frank B. Jones and Gary C. Ness (Ohio State Historical Society, 1987), 10.

The 1787 Northwest Ordinance, which replaced the 1785 Ordinance, carried forth Jefferson's principles, creating an egalitarian basis for wealth generation and political participation in an agrarian society by providing widespread, affordable access to land backed by absolute property rights in fee simple.[87] Thirty-one of the fifty states that currently constitute the United States of America were settled according to the Northwest Ordinance.[88] Passed by the Continental Congress under the Articles of Confederation and affirmed by the US Congress in 1789 under the Constitution, the Northwest Ordinance set a precedent for westward agricultural expansion, assigning the responsibility of administering land to the federal government. After the lots had been surveyed, the land was sold at auction,[89] providing the Confederation with its only real source of independent income.[90] While initial revenue from land sales went to support national government, taxes were owed locally, ensuring a tax base in the newly formed states, and strong property rights assured individual control of land. Jefferson's good friend and protégé James Madison had proposed creating two to five states instead of Jefferson's desired eleven, a suggestion that was adopted in 1785 and integrated into the Northwest Ordinance.[91] Earlier attempts to reserve a portion of mineral discoveries for the government were not preserved in the final ordinance, and mineral rights were therefore held by landholders.[92] The ordinance made provisions for the political formation of each state based on population and the adoption of state constitutions, providing for a period of colonial tutelage through which territories progressed towards statehood. And while it required the provision of public schools and guaranteed individual civil liberties, including religious freedom, trial by jury, habeas corpus, and proportional

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[87] "Thus, in a single decade after peace in 1783, the entire territory between the Alleghenies and the Mississippi River was organized, in theory, on 'American principles,' with guaranteed constitutional rights and forms of government and the method devised whereby the land could pass into secure private ownership and development. The foundation of future American capitalism—private ownership and control of productive resources—was created." See Hughes and Cain, pp. 93–94. "Conservative American historians have argued that the Northwest Ordinance was really a continuation of an established tradition—that the ordinances drew from the colonial charters given to settlers from England. Constitutional historians have argued that the provisions for the 'future' relationship between the states and the Confederation government laid the groundwork for the writing of and acceptance of the Constitution." See R. Douglas Hurt, "Historians and the Northwest Ordinance," *The Western Historical Quarterly* 20 (August 1989): 261.

[88] Hughes and Cain, *American Economic History*, 94.

[89] The public auction allowed land to leave government hands and enter the free market; the process occasionally favored speculation, especially at the outset of the Northwest Ordinance, when land was available only in large quantities. Initially, land was sold at auction in parcels of 640 acres for a low-bid minimum of $1/acre. Minimum parcel size was reduced to 320 acres (in 1800) and then to 160 acres (in 1804). In 1820, the minimum parcel size was reduced again, to 80 acres, and the minimum price was set at $1.25/acre, with credit terms abolished. Finally, in 1832, minimum parcel size was cut to 40 acres. See Hughes and Cain, *American Economic History*, 94–97.

[90] Hughes and Cain, *American Economic History*, 92.

[91] Berkhofer, "Jefferson, the Ordinance of 1784, and the Origins of the American Territorial System," 244–256.

[92] Hughes and Cain, *American Economic History*, 91.

representation, it also prohibited primogeniture, entail,[93] and, selectively, slavery.[94,95] All of the territories between the Alleghenies and the Mississippi and eventually the territory in the Louisiana Purchase in 1803 were settled according to the plan. It was not until westward expansion arrived at the arid plains that the size of individual lots changed.[96]

The Northwest Ordinance framed rights and forged a structure for the enlargement of the United States while setting down a system of land distribution. Historian Harold Hyman emphasizes its unprecedented effects:

> [T]he framers of the Northwest Ordinance, years before the Bill of Rights graced the Constitution, increased individuals' access to ownership of land, subsidized public education, and stabilized property rights in the territories as preconditions to the enhancement of liberty. They institutionalized the pursuit of happiness by dramatically and singularly enlarging individuals' access to landed property, to education, and to legal remedies for securing rights.[97]

Article III of the Northwest Ordinance proclaimed: "Religion, morality and knowledge being necessary to good government and the happiness of mankind, schools and the means of education shall forever be encouraged."[98] In considering how to endow the citizens of their fragile republican experiment, America's founders were aware of the basic importance of education in a democratic setting. In the early republic, local schools, which were funded through various channels,[99]

[93]Both entail and primogeniture were practices that governed the "intergenerational transfer of wealth." Primogeniture was the dominant English practice whereby all wealth was passed, undivided, to the firstborn son. Colonial inheritance laws varied considerably, but most New England and Middle colonies followed multigeniture, whereas primogeniture prevailed in the Southern colonies—as well as New York and Rhode Island—until the 1790s. See Lee J. Alston and Morton Owen Schapiro, "Inheritance Laws Across Colonies: Causes and Consequences," *The Journal of Economic History* 44: 277–287. The OED defines "entail" as "the settlement of the succession of a landed estate, so that it cannot be bequeathed at pleasure by any one possessor; the rule of descent settled for any estate; the fixed or prescribed line of devolution." See *Oxford English Dictionary*, 2nd ed., OED Online, (Oxford: Oxford University Press, 1989), accessed December 2005.

[94]In an attempt to "'[prevent] this abominable crime from spreading itself over the new country,'" Jefferson proposed a ban on slavery west of the Alleghenies in his 1784 Ordinance. The measure was defeated in Congress, and the Northwest Ordinance banned slavery only in territory north of the Ohio River. See Hughes and Cain, *American Economic History*, 91–92.

[95]Tindall and Shi, *America: A Narrative History*, 286–289.

[96]Hughes and Cain, *American Economic History*, 93–94.

[97]Harold M. Hyman, *American Singularity: The 1787 Northwest Ordinance, the 1862 Homestead and Morrill Acts, and the 1944 G.I. Bill* (Athens, GA.: The University of Georgia Press, 1986), 20.

[98]"An ordinance for the government of the territory of the United States North West of the river Ohio," in *The Northwest Ordinance: Essays on its Formulation, Provisions, and Legacy*, ed. Frederick D. Williams (East Lansing: Michigan State University press, 1988), 125.

[99]The economists Claudia Goldin and Lawrence Katz describe the early common school system as a "patchwork quilt," with frequent variations. In the early republic, funding for schools was usually obtained through taxation at the local level, but legislation was required to enable towns to levy taxes. By the 1820s, most Northeast states had completed this step. Initially, the funding

Table 7.7 Taxation and finance in Lexington, Massachusetts, 1874

Lexington, 1874	
Population	2,435
Total valuation	$2,946,424
Valuation of real estate	$2,370,730 (80% of total)
Valuation of personal estate	$ 575,694 (20% of total)
Number of polls	731
Rate of tax	$13 per $1000 (1.3%)
Total amount of tax assessed	$40,644
Town grant	$35,591
State tax	$3,000
County tax	$2,053
Tax assessed on basis of estate tax rate	$38,304 (94% of total)
Total expenditures	$68,333
Capital improvements to buildings and roads	$12,978
Payment of debts and accompanying interest	$19,043
Police	$328
Fire department	$1,041
Support of poor	$3,066
Total funding for schools	$12,759
Funding by town	$12,517 (98% of total)
Funding by state	$242 (2% of total)
Percentage of town expenditure devoted to schools	19%
Number of students	553
Average daily attendance	366

Note: Additional town funding came from such varied sources as highway taxes, dog licenses, etc.
Source: Based on data from *Report of the Town Officers of the Town of Lexington, for the Year Ending Jan. 31, 1875* (Arlington, 1875)

were accessible to free youths.[100] Table 7.7 offers a breakdown of taxation and finance in a New England town, c. 1874. A prominent historian writes that formal education in the colonies grew out of a breakdown in traditional communal life, the previous site of education and socialization, in the context of the wilderness of the New World: "The famous succession of laws passed in Massachusetts and Connecticut after 1647 . . . expressed more than a traditional concern with schooling,

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of schools involved state funds that drew from public land sales, local taxes, state taxes, and rate bills (tuition fees). In the larger northeast cities, a system of private schools arose alongside "pauper" schools, with both institutions occasionally receiving public funding. The movement for free schools focused on the abolition of rate bills and pauper schools; this goal was achieved gradually, with each state enacting legislation, and met in the 1870s. In the North, for example, New Hampshire never had rate bills; Massachusetts abolished its rate bills in 1820; and New Jersey did not formally do so until 1871. The former Confederate states passed free schooling legislation in the 1870s. See Claudia Goldin and Lawrence F. Katz, *The "Virtues" of the Past: Education in the First Hundred Years of the New Republic*, NBER Working Paper No 9958 (Cambridge: National Bureau of Economic Research, 2003), 12–19, 48.

[100] Goldin and Katz, "The 'Virtues' of the Past: Education in the First Hundred Years of the New Republic," 9–10.

and more even than a Puritan need for literacy. It flowed from the fear of the imminent loss of cultural standards, of the possibility that civilization itself would be 'buried in the grave of our fathers.'"[101]

The Northwest Ordinance extended the New England township model of school administration across the Midwest and, by reserving land in each township to support public schools, implemented a system of decentralization and overlapping authority between state, county, and municipal interests. The 10th Amendment of the United States Constitution reserved the power of education to the states.[102] When each state wrote its own constitution, the control and application of the funds from these reserved sections in each state varied. Some states declared direct control of the revenue and centralized the application of these funds to the schools, while others left control of the revenue to each township to fund their schools independently.[103]

Local education systems in the 18th century focused on common schools.[104] By 1850, when 80% of free Americans and 84% of youths[105] lived in small towns or rural settings, the dominant system was that of "quasi-public common schools," funded through taxes and rate bills.[106,107] Emanating from the New England region, the movement for free schools spread through the nation by the 1870s[108]; through these means, America came to lead the world in education, as reflected in Table 7.8 and Fig. 7.3.

[101] Bernard Bailyn, *Education in the Forming of American Society: Needs and Opportunities for Study* (Chapel Hill: Published for the Institute of Early American History and Culture at Williamsburg, Va., by the University of North Carolina Press, 1960), 27.

[102] Goldin and Katz, "The 'Virtues' of the Past: Education in the First Hundred Years of the New Republic," 12.

[103] John C. Eastman, "When Did Education Become a Civil Right? An Assessment of State Constitutional Provisions for Education 1776–1900," *The American Journal of Legal History* 42, no. 1 (January 1998): 10–11; Dennis Denenberg, "The Missing Link: New England's Influence on Early National Educational Policies," *The New England Quarterly* 52 (June 1979): 220–221.

[104] High schools did not become widespread until the "high school movement" of 1910–1940 installed "virtually universal public secondary education" in the United States, the first country to experience that transformation in schooling. Indeed, prior to the high school movement, in 19th century America, high schools were seen as "elitist institutions" that only served a small group of college-bound students. See Claudia Goldin and Lawrence F. Katz, "Human Capital and Social Capital: The Rise of Secondary Schooling in America, 1910-1940," *Journal of Interdisciplinary History* 29, no. 4 (Spring 1999): 683–723.

[105] Defined as 5–14 year olds.

[106] New York State's statistical report on Common Schools from January 1829, for example, indicates that 480,041 children were taught in the 8,872 districts that submitted reports. $100,000 was provided from the state treasury, and $297,048.44 came from rate bills paid by individuals. See S. S. Randall, *A Digest of the Common School System of the State of New-York* (Albany, 1844), 83. The rate system was abolished in New York in 1849, and district taxes took the place of the rate tax. $691,687.94 was provided through district taxes in 1854–1855. See Rolland Maclaren Stewart, *Co-operative Methods in the Development of School Support in the United States* (Iowa City, 1914), 91.

[107] Goldin and Katz, "The 'Virtues' of the Past: Education in the First Hundred Years of the New Republic," 18.

[108] Goldin and Katz, "The 'Virtues' of the Past: Education in the First Hundred Years of the New Republic," 15–46.

Table 7.8 Estimated primary school enrollment rate (per 10,000 population)

	1830	1850	1870	1882	1890	1910
USA	1,500	1,800	1,702	1,908	1,985	1,828
UK	900	1,045	–	1,107	1,261	1,648
France	700	930	1,125	1,382	1,450	1,414
Prussia/Germany	1,700	1,600	–	1,547	1,642	1,570
Italy	300	–	611	681	874	927
Argentina	–	–	–	511	709	944
Mexico	–	–	–	457	487	563
Brazil	–	–	119	207	218	271
India	–	–	–	–	94	147

Source: Richard A. Easterlin, "Why Isn't the Whole World Developed?" *The Journal of Economic History* 41 (March 1981): 18–19, Table 1

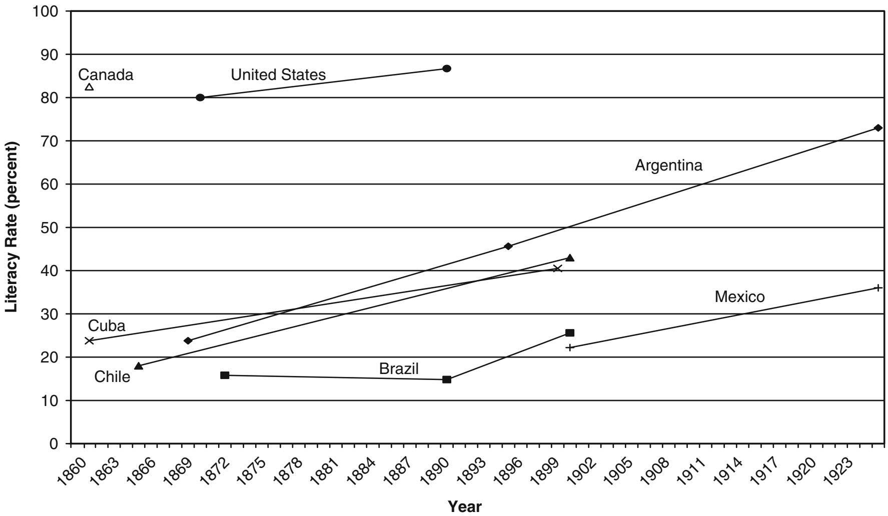

Fig. 7.3 Literacy rates in the Americas, 1860–1925. Notes: Data on literacy rates is provided for Ages 6+ (Argentina, 1869, 1895); Ages 7+ (Brazil, 1872, 1890, 1900; Chile, 1865; Cuba, 1861); Ages 10+ (Argentina, 1925; Chile, 1900; Cuba, 1899; Mexico, 1900, 1925; United States, 1870, 1890); and All Ages (Canada, 1861). Source: Based on data from Elisa Mariscal and Kenneth L. Sokoloff, "Schooling, Suffrage, and the Persistence of Inequality in the Americas, 1800–1945," reprinted from *Political Institutions and Economic Growth in Latin America: Essays in Policy, History, and Political Economy*, ed. Stephen Haber with permission of the publisher (Stanford, CA: Hoover Institution Press, 2000), pp. 172–173, Table 1. Copyright © 2000 by the Board of Trustees of the Leland Stanford Junior University

The Constitution

In September 1786, when only five out of thirteen states sent representatives to the Annapolis Convention in order to discuss commercial problems, promise was born out of frustration in the form of a suggested subsequent convention in Philadelphia. Alexander Hamilton, the staunch nationalist delegate from New York, proposed the Philadelphia convention to allow the consideration of measures necessary "'to render the constitution of the Federal Government adequate to the exigencies of the Union.'"[109] In February 1787, the Continental Congress approved the resolution for a convention to revise the Articles of Confederation. What followed was a 4-month long meeting, which involved fifty-five delegates from the thirteen states and produced a draft of the Constitution.

The Constitution solidified a "republican" system of government, essentially establishing America as a democratic republic—or a representative democracy. American historian Adrienne Koch provides insight into the revolutionary nature of the decision: "European theory had made Republicanism, understood as the theory of representative democracy, familiar. Only America ... could claim to have taken the concept of popular government, through elected representatives of 'we the people,' out of the realm of pure theory and into the realm of experimental practice."[110]

James Madison, who occupied a central position in the drafting of the Constitution, championed representative democracy, rallying against the suggestion that America embrace "simple," direct, popular democracy. Recognizing popular democracy as failing to provide a check against the potential tyranny of the majority, he wrote:

> [A] pure democracy ... can admit of no cure for the mischiefs of faction. ... Hence it is that such democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths. Theoretic politicians, who have patronized this species of government, have erroneously supposed that by reducing mankind to a perfect equality in their political rights, they would, at the same time, be perfectly equalized and assimilated in their possessions, their opinions, and their passions.[111]

The Constitution provided for a much more powerful federal authority than that established by the Articles of Confederation, albeit an authority mediated by an elaborate system of checks and balances among the legislative, judicial, and executive branches of national government. It called for a bicameral Congress composed of the Senate and House of Representatives and vested Congress with the additional powers to create money, regulate interstate and foreign commerce, and levy taxes,

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[109] Quoted in Tindall and Shi, *America: A Narrative History*, 300.

[110] Adrienne Koch, Introduction to *Notes of Debates in the Federal Convention of 1787 Reported by James Madison* (New York: W. W. Norton, 1987), xx.

[111] James Madison, "Federalist No. 10," (November 22, 1787) in Alexander Hamilton, James Madison, and John Jay, *The Federalist* (New York: The Modern Library, 2000), 58.

leaving the regulation of intrastate economic activity to the states. Only the states had the right to issue charters of incorporation and thereby directly set the terms of corporations' economic activity; the federal government could only regulate economic activity as it occurred across state lines.

The issue of economic regulation revealed certain tensions over federal versus state power. Madison initially advocated a strong state with respect to economic activity, in order to better protect the general welfare. As historian John W. Brabner-Smith relates, "On August 1787, not satisfied with the specifically enumerated powers which were offered to replace the general 'welfare' power adopted by the Constitutional Convention from his Virginia Resolutions, James Madison proposed to the Convention the power, 'to grant charters of incorporation in cases where the public good may require them, and the authority of a single State may be incompetent . . . Charles Pinckney at the same time also introduced several additional powers, singularly including this same power to grant charters to corporations.'[112] Madison then reiterated the idea of a federal charter during the final days of the Convention, proposing that the federal government at least have the power to permit the granting of charters of incorporation where state statutes were incompetent and the interests of the United States might require it."[113] Yet some of the most influential delegates feared such federal authority over the nascent nation's economy could lead to failure when it came time for ratification, and the federal power to charter firms was not included in the document.

Another major debate at the Constitutional Convention centered on the form that Congress should take. The "Virginia Plan," which provided for more extensive federal authority over states, proposed a bicameral Congress with a lower house elected by popular vote and an upper house composed of nominees from state legislatures chosen by the lower house. The plan suggested a separation of legislative, judicial, and executive branches and endowed the national government with the power to enact laws that were binding upon states and individuals. The "New Jersey Plan" sought to preserve the Confederation's equal representation of states with a single house of Congress, vested with the power to levy taxes and regulate commerce as well as to name a plural executive and Supreme Court. The delegates came to consensus on the need for a central government with the authority to levy taxes, regulate commerce, raise an army, and enact binding laws, but the issue of representation persisted. Finally, the "Great Compromise" allowed for a bicameral Congress, through which representation in the House of Representatives was determined by population, while representation in the Senate was divided by states.[114]

Implicit in the debate over representation—beyond the question of states' rights—was a fear over the balance of elite and democratic power. The questions of how democracy, with its provision of political equality, and capitalism, with its tendency to exacerbate economic inequalities, might clash in the American

[112] John W. Brabner-Smith, "Federal Incorporation of Business," *Virginia Law Review* 24, no. 2 (December 1937): 159.

[113] Brabner-Smith, "Federal Incorporation of Business," 160–161.

[114] Tindall and Shi, *America: A Narrative History*, 303–304.

system—and how this system might be constructed to ease this tension—arose in the process of drafting and ratifying the Constitution. During the Convention, as the Congress debated senatorial term lengths, Madison suggested that the Senate, with its weight of "wisdom & virtue,"[115] might guard against the "danger in all cases of interested coalitions to oppress the minority."[116] He elaborated on the competing interests and groups in America and of the necessity of a government to mediate and check those interests:

> In all civilized Countries the people fall into different classes having a real or supposed difference of interests. There will be creditors & debtors, farmers, merchants, & manufacturers. There will be particularly the distinction of rich & poor. It was true as had been observed we had not among us those hereditary distinctions, of rank which were a great source of the contests in the ancient Government as well as the modern States of Europe, not those extremes of wealth or poverty which characterize the latter. We cannot however be regarded even at this time, as one homogenous mass, in which every thing that affects a part will affect in the same manner the whole. In framing a system which we wish to last for ages, we should not lose sight of the changes which ages will produce. An increase of population will of necessity increase the proportion of those who will labour under all the hardships of life, & secretly sigh for a more equal distribution of its blessings. These may in time outnumber those who are placed above the feelings of indigence. According to the equal laws of suffrage, the power will slide into the hands of the former. No agrarian attempts have yet been made in this Country, but symptoms, of a leveling spirit, as we have understood, have sufficiently appeared in a certain quarters to give notice of the future danger. How is this danger to be guarded against on republican principles?[117]

In the months after the Constitutional Convention, the pro-Constitution Federalists and the anti-Constitution anti-Federalists fiercely campaigned to respectively encourage or block Constitutional ratification. In Essay No. 10 of *The Federalist*, a series of essays instigated by Alexander Hamilton supporting constitutional ratification and released in 1787 and 1788, Madison argued for a republican system of government based on large states that might balance the diverse interests of their inhabitants. He returned to the theme of the danger of factions and the central importance of property ownership, writing: "the most common and durable source of factions has been the various and unequal distribution of property. Those who hold and those who are without property have ever formed distinct interests in society."[118] Madison sought to present government as providing the mechanism to secure and balance an egalitarian political system against an inegalitarian economic pattern. Republicanism, in his estimation, would ballast against the volatile mix of economic inequality and political equality. The realities of inequality in terms of political rights and asset holdings are presented in Table 7.9.

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[115] *Notes of Debates in the Federal Convention of 1787 Reported by James Madison* (New York: W. W. Norton, 1987), 195 (June 26, 1787).

[116] *Notes of Debates in the Federal Convention,* 194 (June 26, 1787).

[117] *Notes of Debates in the Federal Convention,* 194 (June 26, 1787).

[118] Madison, "Federalist No. 10," 56.

Table 7.9 Measure of inequality and asset distribution in the United States, 1774 and 1860

	Percentage held by Top 1%	Percentage held by Top 10%	Gini coefficient
1774 (13 colonies) Free households	12.6%	49.6%	0.642
1860 Free adult males	29.0%	73.0%	0.832

Source: Jeffrey G. Williamson and Peter H. Lindert, *American Inequality: A Macroeconomic History* (New York: Academic Press, 1980), 38, Table 3.1

Post-Independence Legal Transformation

Ultimately, the Federalists prevailed, and the Constitution was ratified in 1788. Following ratification, as the 18th century drew to a close, an unprecedented shift in the American legal tradition empowered judges to effectively take control of US development by overriding legislative decisions. As Chap. 13 explains in detail, judges, especially those of the Supreme Court, took the initiative to strengthen property rights and promote development through application and innovation in common law doctrine. The eventual fusion of judicial and legislative functions, "undoubtedly known only in very attenuated form in late 16th-century and early 17th-century England," came into full bloom in America in the practice of judicial review, whereby courts might overturn legislation.[119] Courts were therefore able to take a more active role in lawmaking, in collaboration with legislative bodies.

Focusing on the construction of the market framework, legal theorist J. Willard Hurst explains the bold impact that law has had on resource allocation in America. "[I]n a society which believed that in economic creativity it held the means to fashion new standards of human dignity,"[120] the United States "made bold use of taxing and spending powers of national, state, and local governments to help create the framework of economic growth. Resource allocation by law was the more striking in [American] history because we placed great reliance on broad dispersion of economic decision making into private hands through the market, implemented through the law of property and contract."[121]

This more active role was readily embraced, legal historian Morton Horwitz argues, by 19th century American judges, who approached the law as an instrument for social change. This approach marked a distinct departure from the attitude of 18th century American judges, who saw law an "an eternal set of principles expressed in custom and derived from natural law" and relegated social change to

[119] Huntington, *Political Order in Changing Societies*, 112.

[120] Willard Hurst, "The Law in United States History," *Proceedings of the American Philosophical Society*104, no. 5 (October 1960), 519.

[121] Hurst, "The Law in United States History," 519.

the jurisdiction of legislation.[122] Horwitz's case for the emergence of an "instrumental" concept of private law in the United States, which he pinpoints as a 19th century phenomenon, pays particular attention to how "the common law performed at least as great a role as legislation in underwriting and channeling economic development."[123] No neutral force, the legal system, in its instrumental capacity, promoted development while "enabl[ing] emergent entrepreneurial and commercial groups to win a disproportionate share of wealth and power in American society."[124]

Horwitz cites a revolution in the concept of property ownership as a pillar in the shift in attitude towards private law. Previously, "the right to property had been the right to absolute dominion over land, and absolute dominion, it was assumed, conferred on an owner the power to prevent any use of his neighbor's land that conflicted with his own quiet enjoyment."[125] In the 19th century, "the idea of property underwent a fundamental transformation—from a static agrarian conception entitling an owner to undisturbed enjoyment, to a dynamic, instrumental, and more abstract view of property that emphasized the newly paramount virtues of productive use and development."[126] 18th century property rights abided by two theories: the first—rule of natural uses—was "an explicitly antidevelopmental theory" that preferenced natural use of land; the second—rule of priority—prioritized previous development and was functionally antidevelopment, insofar as it was invoked to prevent future conflicting development.[127] In the 19th century, however, "judges began trying to break away from the antidevelopmental consequences of common law doctrine," and priority and natural use took on "different operational meanings."[128] Priority, "measured … from the time that a new technology appears," shifted to encourage investment risks by "confer[ring] an exclusive property right on the first developer" rather than the first owner.[129]

The building of mills and dams "gave rise to the first important legal questions bearing on the relationship of property law to private economic development,"[130] vis-à-vis water rights. In the case of *Palmer v. Mulligan* (1805), the New York Supreme Court allowed an upper riparian mill owner to obstruct the flow of water for his mill, despite the injury he posed to other riparian proprietors in so doing. Taken with *Platt v. Johnson* (1818), *Palmer* stands as a "turning point in American

[122] Morton J. Horwitz, *The Transformation of American Law, 1780–1860* (Cambridge: Harvard University Press, 1977), 30.
[123] Ibid., 1.
[124] Ibid., xvi.
[125] Ibid., 31.
[126] Ibid.
[127] Ibid., 32.
[128] Ibid., 33.
[129] Ibid., 33.
[130] Ibid., 34.

legal development,"[131] marking the divergence of "private economic loss" and "judicially determined legal injury."[132]

The evolution of the Massachusetts Mill Dam Act provides an instance of statute-driven, pro-development legislation enacted in the name of the public good and preserved for private profit through the support of the judiciary. First passed by Massachusetts's colonial legislature in 1713, the Act included a provision whereby property owners might receive compensation for minor flooding on their property caused by the raising of mill dams,[133] which were then considered instruments of public enterprise. This provision stood in conjunction with the common law claim of damages based on trespass or nuisance. In 1795, however, an amendment to the Act limited the damages that a property owner whose land was flooded could claim to yearly compensation for actual losses in that year, and the mill owner was excused from seeking prior court permission to flood his neighbor's land.[134] By this point, mills—which now included saw, paper, and cotton mills in addition to the original grist mill—were recognized as tools of private enterprise.[135]

As Horwitz enumerates, the Act's limitation of compensation to an annual payment of damages excluded "four important alternative avenues to relief," namely: (1) The action of trespass, "in which a plaintiff was not required to prove actual injury in order to recover"; (2) The imposition of "punitive damages in trespass or nuisance," through which the common law provided a negative incentive to combat the gain achieved through an individual's seizure of another's property; (3) The resort to self-help allowed by the common law, in which property owners seeking to "abate a nuisance" might destroy offending property; and (4) The "possibility of permanently enjoining a mill owner for having created a nuisance."[136] In ensuing years, the judiciary upheld the Act and even extended it in 1827, and mill proprietors "succeeded in inducing the court to extend the act to cover a situation that the legislature could scarcely have envisioned," allowing "mill owners virtually unlimited discretion to destroy the value of lands far in excess of any benefit they might possibly receive."[137]

The early 19th century in America also witnessed the enactment of the world's first limited liability statutes, which sought to protect investors by using the government to shift risks to creditors, away from shareholders.[138] In the years leading up to the War of 1812, the 1807 Embargo and 1809 Nonintercourse Act collapsed

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[131] Ibid., 37.

[132] Ibid., 38.

[133] Ibid., 47.

[134] Ibid., 47–48.

[135] Ibid., 49.

[136] Ibid., 48.

[137] Ibid., 50.

[138] David A. Moss, *When All Else Fails: Government as the Ultimate Risk Manager* (Cambridge: Harvard University Press, 2002), 54.

trade with Great Britain.[139] In 1809, state legislatures began granting unprecedented numbers of corporate charters; in a bid to compete with Massachusetts, New York developed general incorporation laws in 1811 that offered limited liability as a means to mobilize capital and spur development.[140] Limited liability, which Columbia President Nicholas Murray Butler described in 1911 as "'the greatest single discovery of modern times,'"[141] conferred "a special privilege to manufacturing corporations, on the grounds that it would induce additional investment in this small but increasingly vital sector of the economy."[142] Despite its long history of promoting manufacturing, Massachusetts mandated *unlimited* liability for shareholders, a move that hindered the Commonwealth's ability to compete with surrounding states, many of whom were adopting limited liability.[143] In 1830, succumbing to the argument that Massachusetts's unlimited liability laws were spurring capital flight, the state legislature reversed its 1809 law and extended limited liability.[144]

Ideological Clashes in the American Republic

Drawing on the ideals and teachings of the Scottish Renaissance, America's founding fathers remained consistently sensitive to the conditions that would best create and conserve a virtuous and industrious republic.[145] The American republic arose in the midst of a "watershed in the economic as well as the intellectual history of Western Europe," as society was transformed by a commercialization that upset traditional modes of life.[146] The republicanism embraced by the American founders contained an inherent paradox, combining "the traditional republican spirit of classical antiquity" with "the new imperatives of a more modern commercial society."[147] In Revolutionary America, it was agreed that republican government was only sustainable when supported by an "extraordinary society of distinctively moral people."[148]

Alexander Hamilton and Thomas Jefferson typically stand as two opposing perspectives on political economy in the nascent United States and can be used to illustrate an ideological dichotomy. Hamilton espoused a pro-development, pro-diversification economic strategy. A Federalist, he supported a concentration of

[139] Ibid., 55.
[140] Ibid.
[141] Quoted in Ibid., 53.
[142] Ibid., 57.
[143] Ibid., 59.
[144] Ibid., 68.
[145] See Drew R. McCoy, *The Elusive Republic: Political Economy in Jeffersonian America* (New York: W. W. Norton, 1980).
[146] Ibid., 17.
[147] Ibid., 10.
[148] Ibid., 5.

power at the national level and oversaw the construction of the first National Bank of the United States. Jefferson, in contrast, generally advanced policies that sought to maintain America as a decentralized agricultural republic far removed from the corrupting influence of European commerce. Notably, his land policy laid the groundwork for a horizontal expansion of the agricultural ideal. Both Hamilton and Jefferson realized the importance of property ownership in shaping the contours of the republic and sought to harness the great potential wealth of the nation, with its abundant land, to maximum effect. Their models of capitalism were as different as their models of political governance. Hamilton wanted a strong federal government and a national bank; Jefferson wanted minimal government and no bank.

Beyond realizing a theoretical system, the decision to govern America as a republic was a historically-motivated one, relying on classical models to advance a structure of government quite distinct from current models. Rather than looking to the European monarchies, framers of the early American republic referenced the ancient republic of Sparta.[149] In developing their plans for America's social structure, Hamilton and Jefferson relied on ideas put forth by the great thinkers of the Scottish Renaissance, particularly David Hume and Adam Smith.

The argument over American political economy must be considered against the European intellectual backdrop. French and Scottish theorists of the time envisioned states as progressing through various stages of development, from hunting to agricultural to commercial societies. Societies would naturally advance through these stages, propelled forward, it was believed, by population growth and demand for more food and employment.[150] A great debate unfolded in Europe—and extended to America—over whether this social progress was civilizing or degenerative. America, with its small population and vast tracts of land, was thought to be capable of delaying a rapid advance from agriculture to commerce, if it so desired.[151] The structuring of America's political economy thus was considered a moral question as well as a political one.

Where Hamilton sought to grow the economy through diversification into commerce and manufactures, Jefferson advanced a yeoman ideal, attempting to stave off encroaching commerce and advance agricultural specialization. Each believed they had the best interests of America at heart, and each grounded their approach in the theories of European reformers.

Thomas Jefferson: Republicanism and Agriculture

Thomas Jefferson sought a diffuse expansion—specifically, a westward expansion—as a way to permit the horizontal extension of an agricultural society. A traditional republican, Jefferson located the yeoman at the center of his

[149] Ibid., 23.

[150] Ibid., 19–20.

[151] Ibid., 20–21.

scheme of virtuous agricultural development. In his *Notes on the State of Virginia*, written when Jefferson was governor of that state, he makes his classic plea—described as "a centerpiece of the republic's cultural heritage, a quintessential expression of its impassioned concern for the natural, earthbound virtue of a simple and uncorrupted people"[152]—for the preservation of agricultural self-sufficiency in the face of encroaching European commerce, elevating the yeoman as a virtuous toiler while preaching against the dependency bred through manufacturing:

> The political oeconomists of Europe have established it as a principle that every state should endeavour to manufacture for itself: and this principle, like many others, we transfer to America, without calculating the difference of circumstance which should often produce a difference of result. In Europe the lands are either cultivated, or locked up against the cultivator. Manufacture must therefore be resorted to of necessity not of choice, to support the surplus of their people. But we have an immensity of land courting the industry of the husbandman. Is it best then that all our citizens should be employed in its improvement, or that one half should be called off from that to exercise manufactures and handicraft arts for the other? Those who labour in the earth are the chosen people of God, if ever he had a chosen people, whose breasts he had made his peculiar deposit for substantial and genuine virtue. It is the focus in which he keeps alive that sacred fire, which otherwise might escape from the face of the earth. Corruption of morals in the mass of cultivators is a phaenomenon of which no age nor nation has furnished an example. It is the mark set on those, who not looking up to heaven, to their own soil and industry, as does the husbandman, for their subsistence, depend for it on the casualties and caprice of customers. Dependance begets subservience and venality, suffocates the germ of virtue, and prepares fit tools for the designs and ambition ... While we have land to labour then, let us never wish to see our citizens occupied at a work-bench, or twirling a distaff. Carpenters, masons, smiths, are wanting in husbandry: but, for the general operations of manufacture, let our work-shops remain in Europe. It is better to carry provisions and materials to workmen there, than bring them to the provisions and materials, and with them their manners and principles. The loss by the transportation of commodities across the Atlantic will be made up in happiness and permanence of government. The mobs of great cities add just so much to the support of pure government, as sorts do to the strength of the human body. It is the manners and spirit of a people which preserve a republic in vigour. A degeneracy in these is a canker which soon eats to the heart of its laws and constitution.[153]

Jefferson's strong emphasis on agriculture as the lifeblood of American republicanism drew on the writings of the Scottish reformer Adam Smith, who identified America's natural comparative advantage—its abundant land and scarce population—as containing the potential to delay the next stage of social progress, i.e., commerce. In his 1776 classic, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Smith advised America against halting European imports and developing domestic manufactures, which "would retard instead of accelerating the further increase in the value of [American] annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and

[152]Ibid., 13.

[153]Thomas Jefferson, *Notes on the State of Virginia* (New York: Penguin, 1999), 170–171.

greatness."[154] Instead, Americans might persist as the ideal of the planter, who "cultivates his own land, and derives his necessary subsistence from the labour of his own family, is really a master, and independent of all the world."[155]

Jefferson, resistant to the consolidation of power promoted by Hamilton, sought to prolong the natural advantage of the American republic through westward expansion. Jefferson spearheaded the Louisiana Purchase of 1803, ensuring "a continuously expanding 'empire of liberty,'" peopled with the agricultural class that formed the backbone of virtuous republicanism.[156] In so doing, Jefferson sought to combat the inequality and wretched poverty he had observed in Europe.[157] By providing for the land to be purchased outright from the federal government, Jefferson effectively loosened national authority and secured local and state rights. A minimalist state could expand to govern a continent.

Alexander Hamilton: Federalism and Commerce

In contrast to Jefferson and his groundings in Smith, Alexander Hamilton adopted David Hume's idea that "it is a prosperous commercial state rather than a pinched and rustic one that produces a humane, sociable, and virtuous people," a state whose "common man of virtue was not the yeoman farmer but the skilled city artisan."[158] Hume, having witnessed Scotland's development from a totally agricultural economy, was particularly well-suited to influence Hamilton's approach to an analogous situation.[159] Hamilton's involvement with government was primarily concerned with the "potential for growth—an expanding population, limitless natural resources, vast tracts awaiting tillage, a vigorous people," and the question of how this growth might be practically achieved.[160] In particular, Hamilton envisioned growth as necessitating centralized federal authority and the mobilization of the merchant classes.

Drawing on the 18th century European debate over the nature of luxury to promote industry and economic development, Hamilton embraced Hume's position that luxuries provided the incentive to greater productivity. Hume, writing at a time where transport overland was extremely expensive, detailed an argument for strength through diversification in his 1752 essay "Of Commerce":

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[154] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Indianapolis, IN: LibertyClassics, 1979), 367.
[155] Ibid., 379.
[156] McCoy, *The Elusive Republic*, 204.
[157] Ibid., 126–127.
[158] Stanley Elkins and Eric McKitrick, *The Age of Federalism* (New York: Oxford University Press, 1993), 110.
[159] Ibid., 258.
[160] Ibid., 115.

> Where manufactures and mechanic arts are not cultivated, the bulk of the people must apply themselves to agriculture; and if their skill and industry encrease, there must arise a great superfluity from their labour beyond what suffices to maintain them. They have no temptation, therefore, to encrease their skill and industry; since they cannot exchange that superfluity for any commodities, which may serve either to their pleasure or vanity. A habit of indolence naturally prevails. The greater part of the land lies uncultivated. What is cultivated yields not its utmost for want of skill and assiduity in the farmers. If at any time the public exigencies require, that great numbers should be employed in the public service, the labour of the people furnishes now no superfluities, by which these numbers can be maintained. The labourers cannot encrease their skill and industry on a sudden. Lands uncultivated cannot be brought into tillage for some years. The armies, mean while, must either make sudden and violent conquests, or disband for want of subsistence. A regular attack or defence, therefore, is not to be expected from such a people, and their soldiers must be as ignorant and unskillful as their farmers and manufacturers.[161]

Early on, Hamilton distanced himself from the theory of classical republicanism, with its claim that men acted in disinterested pursuit of virtue rather than luxury, embraced by many of the founding fathers.[162] Just as Hume disputed the adoption of a Spartan model and instead emphasized the central importance of commerce as an incentive to labor,[163] Hamilton rejected the promotion of America as a virtuous agrarian republic and sought instead to shape a powerful modern state, embracing the inevitability of progression to commerce.[164]

Hamilton "nursed the vision of a great nation, and fully shared the Enlightenment faith that people might rationally design institutions and arrangements capable of reaching their society's inner spirit—and … of galvanizing the American people into exploiting the enormous bounty that lay before them."[165] To this end, in his capacity as the first secretary of the treasury, he sought to fund the national and state debts, secure public credit, establish a national bank and a system of taxation, promote manufacturing, and mobilize capital.

In his 1790 *First Report on the Public Credit*, he recommended funding the federal debt at face value and assuming states' debts. By funding the debt, Hamilton concentrated resources among a particular group of men, building up public credit and capital.[166] Employing taxation to encourage citizens to maintain their standard of living through greater industry[167] and thereby to "stimulate enterprise rather than discouraging it," Hamilton also identified taxation as an opportunity to ensure federal authority.[168]

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[161] David Hume, "Of Commerce," in *Essays and Treatises on Several Subjects*, vol. I: *Essays, Moral, Political, and Literary* (Bristol: Thoemmes Press, 2002), 276–277.

[162] McCoy, *The Elusive Republic*, 133.

[163] Ibid., 81.

[164] Ibid., 133–135.

[165] Elkins and McKitrick, *The Age of Federalism*, 108–109.

[166] Ibid., 117.

[167] Ibid., 112.

[168] Tindall and Shi, *America: A Narrative History*, 328–329.

Far from wincing at the potential for inequalities to be exacerbated by industrial development, Hamilton quickly recognized the inevitability of this trend. At the constitutional convention, Madison agreed with Hamilton's observation that accumulation was a natural effect of liberty: "It was certainly true: that nothing like an equality of property existed: that an inequality would exist as long as liberty existed, and that it would unavoidably result from that very liberty itself."[169] Hamilton's strategies for growth, focusing on concentrating and mobilizing capital to spur productivity and industry, came to bear in his 1791 *Report on the Subject of Manufactures*, which detailed the many economic advantages of manufacturing, especially in response to the restrictions of European mercantilism.[170] Stressing the greater productivity that came with the division of labor in manufacturing, as distinguished from the household manufactures extolled by Jefferson and Franklin, Hamilton insisted that implementing free trade would not displace domestic manufacturing.[171] In his *Report*, Hamilton spoke to the importance of manufacturing in attracting skilled immigrants:

> [T]he results of human exertion may be immensely increased by diversifying its objects. When all the different kinds of industry obtain in a community, each individual can find his proper element, and can call into activity the whole vigour of his nature. And the community is benefitted by the services of its respective members, in the manner, in which each can serve it with most effect . . . To cherish and stimulate the activity of the human mind, by multiplying the objects of enterprise, is not among the least considerable of the expedients by which the wealth of a nation may be promoted . . . The spirit of enterprise, useful and prolific as it is, must necessarily be contracted or expanded in proportion to the simplicity or variety of the occupations and productions, which are to be found in a Society. It must be less in a nation of mere cultivators than in a nation of cultivators and merchants; less in a nation of cultivators and merchants, than in a nation of cultivators, artificers and merchants.[172]

Hamilton encouraged an imitation of the British system of public finance, and opposition was fierce in the United States. "Many of Hamilton's opponents came to fear nothing less than a conspiracy to corrupt American society and smash the republican experiment by imitating British forms, manners, and institutions."[173] What Hamilton framed as forward-looking progress was perceived by traditional republicans as true regression.[174] Despite the vehement criticism of the *Report on Manufactures*, however, many of its suggestions were ultimately implemented.

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[169] *Notes of Debates in the Federal Convention*, 196.

[170] Douglas A. Irwin, *The Aftermath of Hamilton's "Report on Manufactures,"* NBER Working Paper No. 9943 (Cambridge: National Bureau of Economic Research, 2003), 3–4.

[171] McCoy, *The Elusive Republic*, 149.

[172] Alexander Hamilton, *Report on the Subject of Manufactures*, December 5, 1791, in *Alexander Hamilton: Writings* (New York: The Library of America, 2001), 663–664.

[173] McCoy, *The Elusive Republic*, 153.

[174] Ibid., 161.

The Clash Between Jefferson and Hamilton

Jefferson became one of Hamilton's fiercest opponents and, with Madison, threatened his financial plan. The standoff was finally averted by a famous compromise in which Jefferson and Madison agreed not to block Hamilton's plan in return for his support to relocate the nation's capital from New York to a new federal district on the Potomac River. This compromise, however, did not overcome the deeper rift that had developed.

One historian writes that Madison and Jefferson, by attempting to block Hamilton's bank plan in 1790, took "the first random and haphazard steps—themselves scarcely realizing or understanding the implications of what they were doing—toward organizing a political opposition to their own government."[175] Despite the anti-party climate of the time, this conflict would bloom into the birth of partisanship and political parties in America. Jefferson and Hamilton disagreed on more than the proper route to a mutually agreed-upon final goal. They were disputing the goal itself. To this end, the political parties that formed behind them, the Jeffersonian Republicans and the Hamiltonian Federalists (described by Madison, in a singular display of partisanship, as "republicans" and "anti-republicans") cemented irreconcilable differences into distinct factions.[176]

Jefferson's system of westward expansion was a "bold intellectual stroke," insofar as it defied conventional wisdom that republics operated best as small states and overturned the traditional assumption that empire and expansion accompanied "luxury, corruption, and especially despotism."[177] His negotiation of the Louisiana Purchase from France secured control of the Mississippi River and New Orleans, along with an approximately 600 million acre swath of land. Historian Drew McCoy identifies a "central tension in the Jeffersonian conception of a republican political economy. The establishment and security of a relatively simple, peaceful, predominantly agricultural republic paradoxically required a dynamically expansive foreign policy."[178] Indeed, while the measure was largely met with support by Federalists, some Federalists criticized the Louisiana Purchase as unnecessary and threatening, comprising such a large amount of land that it would be impossible to govern: "'Now, by adding an unmeasured world beyond that river,' lamented Fisher Ames, 'we rush like a comet into infinite space.'"[179]

In his two terms in the presidency (1801–1809), Jefferson did not remain strictly devoted to the brand of Republicanism he had initially championed, which focused on agriculture and states' rights. With time, Jefferson changed his views on domestic manufacturing, as prompted by severe foreign trade disruptions from 1807 to

[175] Elkins and McKitrick, *The Age of Federalism*, 224.

[176] Ibid., 268.

[177] McCoy, *The Elusive Republic*, 204.

[178] Ibid., 207.

[179] Fisher Ames to Christopher Gore, October 3, 1803, *Works of Fisher Ames*, vol. 1, ed. Seth Ames (Boston, 1854), 323–324, quoted in McCoy, *The Elusive Republic*, 200.

1814. By 1816, Jefferson, who had once advocated for agricultural specialization as a moral imperative, would argue: "'we must now place the manufacturer by the side of the agriculturist.'"[180] "'Within the 30 years that have elapsed, how are circumstances changed!' Jefferson wrote. '[E]xperience has taught me that manufactures are now as necessary to our independence as to our comfort.'"[181]

A Review of Capitalism and Democracy in the Early US

The case of America, c. 1630–1830, demonstrates the importance of unique circumstances and actors. Having escaped the generally prevailing burdens of a feudal past, the colonies fostered an exceptional and early egalitarianism, resulting in a nascent, well-balanced capitalist democracy. Certainly, the "dual polyarchy" of slavery cast a shadow that would prove difficult to eradicate, forging racially-based inequalities that were ultimately incompatible with democracy, but, at the point of time under examination in this chapter, large swaths of the United States, notably the North, largely escaped the scourge of slavery and its aftermath.

As Engerman and Sokoloff have convincingly argued, the Northern American colonies were, paradoxically, advantaged by the lack of rich factor endowments, which would have encouraged deep inequalities and long-term barriers to development. The comparative scarcity of resources compelled the colonies to attract immigrants to help build the home market by offering small plots of land and the opportunity for local self-government, as well as myriad civil liberties. They diversified their economies into manufactures and trade, and created institutions to try to build local markets as well as export markets. The North was exceptional in lacking the aristocratic element found in the South, but even the southern North American colonies fared better than those in Latin America and the Caribbean, as there were no precious metals to mine and only limited potential for plantation agriculture, (an endowment whose effects are outlined in the previous chapter). In the United States, the paucity of initial natural advantages was outweighed by investments in human resources and effective institutions such as a development oriented set of reforms in the legal system and the spread of public roads and education.

Americans who have not studied this period with some care may see it as an ideal societal model based upon small government and private enterprise. While partially true, its relevance as a model for any contemporary society must be tempered by the particular circumstances that fostered development in the early US context—circumstances that are not replicable in today's world. As this chapter related, early American political leaders, including John Adams and Thomas Jefferson, saw the potential of a strategy of horizontal development based on westward expansion to delay the development of manufactures and thus of inequalities. No modern state has such potential, including the 21st-century United States. The symbiotic relationship

[180] Quoted in Irwin, *The Aftermath of Hamilton's "Report on the Subject of Manufactures,"* 24.
[181] Quoted in Ibid., 24.

between capitalism and democracy flourished in the North first because of high transport costs that ensured the survival of many small markets and small firms and second because of the absence of exploitable, concentrated resources and power-driven technologies; no such circumstances exist today, in the United States or to my knowledge in any modern state. In fact, by 1830, even this context was on its way out; antagonistic symbiosis had already made an appearance in the first integrated textile mills. Similarly, the arrival of the railroad would soon bring radical changes in the size of markets as well as of firms and, with these changes in capitalism, the need for governmental regulation to deal with abuses of private power.

Americans all too often miss another key aspect of these formative years. Legal reforms launched immediately after independence repealed many of the vestigial feudal institutions brought over from Europe that might otherwise have prohibited the political and economic development described above. These reforms were sometimes undertaken by the courts, showing that both the legislative and judicial branches could play a role in economic development. And consensus was never fully achieved on any of these reforms; for instance, while Alexander Hamilton propelled the new nation forward with a remarkable financial system that promoted development, the Jeffersonians closed the first Bank of the United States for ideological reasons.

For 200 years the US enjoyed a remarkable symbiosis between its emerging systems of governance, i.e., capitalism and democracy. Its capitalism was atomistic, where all but a few producers were too small to enjoy any influence on their markets. The pricing mechanism could coordinate economic activity, almost like a natural force such as gravity could coordinate the motion of the planets. Small firms and markets meant that US capitalism could operate almost unguided without any obvious examples of great abuse, for example of common resources. Rain-fed agriculture was a powerful silent contributor to this idealized design. Americans could think of their circumstances as normal, while discounting the abnormalities of the south. At the same time its federal structure of political governance allowed for local democracy through school districts, townships and counties, and states, while a federal government had overall coordinating powers. The strong preference for a weak state meant that there were few dependable links between these levels of government, and James Madison would re-enforce the Constitution when he vetoed the so-called Bonus Bill that would have allowed the federal government to use the proceeds of land sales to finance public infrastructure such as canals. However this same preference for weakness at the center caused Madison to allow the expiration of the First Bank, leaving the US without either a central bank or any other governmental institution with which to intervene in the economy except the courts. This extreme weakness was corrected, temporarily as it turned out, with chartering of a Second Bank in order to help finance the War of 1812. The key to the symbiosis was local government and local firms in small, mostly local markets, a combination that would be rent asunder by the Industrial Revolution.

However, the symbiotic model did not apply to the whole country. The southern states were governed more like Latin America, with their relative lack of attention to urbanization, industry, commerce and indeed education. Despite its superior relative wealth and population at the outset, the south was declining in relative population and living standards as time passed, a situation I return to in Part III. The continuing drive to raise living standards called for remaining attractive to immigrants to build a home market on the one hand, and collective efforts to build a better transport system via canals and river boats on the Mississippi as the 19th century opened. US cities and states shared the notion of governmental corruption with Latin America, but not to the extent that a small minority was systematically exploiting a large majority through oppressive institutions, except special regions in the deep south.

Forty years after the great battle between Jefferson and Hamilton, de Tocqueville found tensions in the resulting hybrid system of capitalism and democracy even before the advent f the new giant firms. De Tocqueville considered the threats to their compatibility, expressing concern that specialization, an outgrowth of competitive capitalism, might eclipse the empowered democracy:

> As the principle of the division of labor is ever more completely applied, the workman becomes weaker, more limited, and more dependent. The craft improves, the craftsman slips back ... Thus, at the same time that industrial science constantly lowers the standing of the working class, it raises that of the masters ... So there is no resemblance between master and workman, and daily they become more different. There is no connection except that between the first and last links in a long chain. One is in a state of constant, narrow, and necessary dependence on the other and seems to have been born to obey, as the other was to command. What is this, if not an aristocracy?[182]

Opportunities created by industry might undermine the egalitarianism assumed in democracies. De Tocqueville warned that "just when the mass of the nation is turning toward democracy, the particular class which is engaged in industry becomes more aristocratic."[183] Of these "little aristocratic societies formed by certain industries in the midst of the vast democracy of our day,"[184] he wrote, "the friends of democracy should keep their eyes anxiously fixed in that direction. For if ever again permanent inequality of conditions and aristocracy make their way into the world, it will have been by that door that they entered."[185]

Like Hamilton and Hume, de Tocqueville envisioned productivity spurred by a desire for luxury, describing an America where "[l]ove of comfort has become the dominant national taste."[186] But he maintained that this desire was in fact nurtured by egalitarianism, rather than propelled by inequality, writing: "equality naturally leads men to go in for industry and trade and ... tends to increase and distribute real property. ... it inspires every man with a constant and eager

[182] Tocqueville, *Democracy in America*, 2:529.
[183] Ibid.
[184] Ibid., 530.
[185] Ibid., 531.
[186] Ibid., 503.

desire to increase his well-being."[187] He maintained that "love of physical pleasures never leads democratic peoples to such excesses" as it does aristocrats.[188] Instead, they pursue luxury as a "tenacious, exclusive, and universal passion, but always a restrained one," with a drive that "can only apply to men of middling fortune."[189] Nonetheless, de Tocqueville did consider the potential motivation tendered by a low level of economic inequality, "[a]mong a people where ranks are more or less equal,"[190] in which the desires of the poor, middle class, and rich mingle and shift:

> [W]hen distinctions of rank are blurred and privileges abolished, when patrimonies are divided up and education and freedom spread, the poor conceive an eager desire to acquire comfort, and the rich think of the danger of losing it. A lot of middling fortunes are established. Their owners have enough physical enjoyments to get a taste for them, but not enough to content them. They never win them without effort or indulge in them without anxiety. They are therefore continually engaged in pursuing or striving to retain these precious, incomplete, and fugitive delights . . . The passion for physical comfort is essentially a middle-class affair; it grows and spreads with that class and becomes preponderant with it. Thence it works upward into the higher ranks of society and thence spreads downward to the people.[191]

While de Tocqueville's intuitions were probably correct, they would be completely overshadowed by changes that he could hardly have imagined. Between 1805 and 1850 the US population grew almost fourfold, and wealth per capita more than doubled. Thus while estimated wealth per capita had grown by less than 50% between 1650 and 1805, it more than doubled in the next 50 years, as shown in Table 7.10. Thus, as he was visiting in the early stages of "modern economic growth" thanks in large measure to industrialization as well as immigration and expansion of the markets. Industrialization would also hasten a "transfer of effective political power from the land-owning classes to those involved in the production, transport, and sale of the products of the industrial age."[192]

More than a century after de Tocqueville's visit, historian Richard Hofstadter looked back on the 19th century and observed: "The United States was born in the country and has moved to the city."[193] Between 1815 and 1860, Jefferson's early yeoman ideal confronted the growing reality of an increasingly urbanized, commercial American society, and "the character of American agriculture was transformed"[194] as farming became a commercial enterprise linked to markets rather than an exercise in virtuous self-sufficiency. The entrepreneurial self-made man displaced the egalitarian agrarian as the American ideal. The farmer himself

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[187] Ibid., 612.
[188] Ibid., 504.
[189] Ibid., 504.
[190] Ibid., 610.
[191] Ibid., 503.
[192] Norrie and Owram, *History of the Canadian Economy*, 170.
[193] Hofstadter, *The Age of Reform*, 23.
[194] Ibid., 38.

Table 7.10 American per capita wealth

Year	Population (millions)	Constant dollars at 1976 Prices
1650	0.05	$1,148
1750	1.171	1,579
1774	2.35	1,782
1805	6.35	1,529
1850	23.67	3,590
1900	76.8	11,757

The wealth estimates between 1650 and 1850 exclude the value of property in slaves.
Source: David Moss, "Constructing a Nation: The United States and Their Constitution, 1763–1792," Harvard Business School Case No. 795-063 (Boston: Harvard Business School Publishing, 1996), 15, Exhibit 9, compiled from Alice Hanson Jones, *Wealth of a Nation to Be* (New York: Columbia University Press, 1980), 78, 81

encountered "the 'corruption' of the trade" and became an entrepreneur, thanks to cash crops, mechanization, and new markets that were made accessible by turnpikes, canals, and railroads and that fueled greater demand.[195] Paradoxically, the demise of the American farmer was due in some part to the easy availability of cheap land, a shortage of labor, and the concomitant temptation to engage in speculation and amass large volumes of land rather than develop and carefully cultivate smaller plots.[196] After the Civil War, in America's "status revolution,"[197] the farmer became one of several professionals whose respectability and authority were diminished by a burgeoning national culture. The great wealth and power concentrated through industrialization eroded a tradition of "local eminence," in which the "small merchant or manufacturer, the distinguished lawyer, editor, or preacher" could "command much deference and exert much influence."[198] In their place arose "agents of the new corporations," possessing "new eminences of wealth and power."[199] Nevertheless, the experience of 200 years of symbiosis between small firms, small markets and local governance would retain a powerful ideological hold on American economic and political discourse, surviving in speeches and textbooks long after it had been bypassed in reality. Indeed, one can argue that the success of that decentralized system put the US in an exceptional place to take advantage of the new opportunities of the Industrial Revolution. There was a huge element of luck in these circumstances; had future success required much greater coordination the US inheritance might have been judged quite differently by future historians.

[195]Ibid., 38–40.
[196]Ibid., 40–41.
[197]Ibid., 139.
[198]Ibid., 135.
[199]Ibid., 137.

Conclusions: Examining Early US Capitalism in International Context

US experience with capitalism could hardly contrast more sharply with the early developmental experiences of the various countries of Central and South America, as examined in the previous chapter. South of the Rio Grande twenty some countries were still enmeshed in economic systems based on continuing use of forced labor, the inadequate provision of public goods for most of its inhabitants, and repressive government. If we were to try to summarize the key differences in a sentence or two, the US was uniquely well placed to embrace the Industrial Revolution because it had developed its human capital as well as its physical infrastructure while developing its factor markets, at least in the north, in ways that permitted it to mobilize a very broad set of resources through its emerging capitalist institutions, such as firms with extraordinary legal powers. If there was a weakness, it might lie in the fact that the new firms would soon be able to challenge a weak state as a source of authority. Why would Latin America, with its initially richer endowments be less well positioned to take advantage of the Industrial Revolution? Paradoxically, those initial advantages seem to have been conducive to the creation of institutions that were "anti-developmental."

As noted by Stanley Engerman and Kenneth Sokoloff in the previous chapter, almost all of Latin America started from circumstances of concentrated factor endowments that provided the opportunity for the Europeans to dominate and brutalize the Amerindians to take advantage of the opening of world markets in a first round of what would now be called globalization. Argentina, Chile, and the southern parts of Brazil were the most significant exceptions. Rich endowments allowed a few people to gain control over those resources and to fashion institutions aimed at maintaining that control. In this sense the United States resembled Europe, in creating a context where no one gained control of great resources for the first 200 years, and instead its cities and towns fostered local development of a diversified set of resources, as Hamilton had suggested they should. A society that had commerce as well as agriculture would be more wealthy than one with only agriculture, and one with manufactures (artificers) as well as commerce and agriculture would be richer still. The critical differences would be in opportunities for the development of human resources and in institutions for mobilizing as well as allocating those resources. Thus, in contrast to a largely static economic theory of comparative advantage, a lack of strong comparative advantages was itself a powerful advantage in that it required the population learn how to govern and develop itself.

Part of North America did have rich endowments, but it was in the far north, where the fur trade was an analog to the South American circumstances, albeit a modest one. To exploit that fur trade the French organized a neo-feudal form of colonialism that stretched thinly from Montreal to the Hudson Bay in the north, and to New Orleans in the South, all linked by inland waterways. With these endowments, the French did not attempt settlement so much as creation of a trading empire that they could control from Quebec and especially from Montreal. Their few expatriates intermarried with the Amerindians rather than trying to enslave them in the Latin American model; so their impact on native societies was much less repressive than those in Latin America, and less developmental as well. Moreover, the French settlements differed from those of the British only a few miles away in similarly latitudes; the French did not recognize tradable private property the way the English did, even along the St. Lawrence where they settled, so they enjoyed neither capitalism nor democracy while they controlled what is now eastern Canada. Instead, they had a trading regime where most of the land remained in the common ownership of the Indian tribes and where two forms of government shared authority, one based on tribes and another based on feudalism and, ultimately, on French monarchy. Had the fur trade been still richer, or the French more determined, these two forms of governance might have clashed as an influx of immigrants threatened to overwhelm the Amerindians, as would happen later under British rule.

The English parts of North America started off as one region, with numerous distinct colonial governments and two economic systems, one based on free labor and the other on slavery, but nowhere was the slave population large relative to the European in parallel to the pattern in Central and South America. Britain reigned over its colonies, but for the most part did not try to rule them. The crown controlled external trade and foreign policies, while appointing governors who relied upon local legislatures to vote on appropriate tax revenues. Thus, where Central and South America were mostly ruled by monarchs claiming divine rights, the English colonies were ruled by a limited monarchy in Britain that accepted even more limited powers in the New World. When England tried to rule more forcefully in North America in the 1770s, it soon had a revolution on its hands.

This contrast between the North American colonies and those in Latin America was apparent even though the British colonies had a variety of local regimes. Despite their differences, these regimes were all predominantly based on light control from England, including the absence of a standing army. Where a British colony had a majority of slaves in the population, as in Jamaica, it too had a standing army, albeit initially under control of the local parliament. In the southern colonies in British North America, there was a mix of slavery and free labor mobility, with free labor predominating in areas where the soil and climate were not conducive to plantation agriculture. Furthermore, there was something close to free labor mobility in the North once indentured servants, who were basically of European stock, had earned their freedom.

The reasons for the sharp differences in organization of North America and the colonies to its south lay not only in the natural resources, as noted above, but also in the demographics. In the continental US, European settlers predominated and accordingly arranged their institutions for their own benefit, permitting oppression of blacks while enjoying exceptional liberties for themselves. Jamaica was the exception, with an English population amounting to only about 10% of the total. While it started with its own parliamentary institutions, backed by a standing army to suppress the majority, once slavery was legally abolished by the English government, Jamaica petitioned for direct rule from London. This surrender of local sovereignty allowed Englishmen to be ruled through a benign pro-slavery monarchy until at least the latter part of the 19th century. Englishmen in Jamaica were no more able to establish capitalism in their first three centuries than were the Portuguese and Spanish in neighboring countries. Rich natural advantages were such a formidable temptation to the establishment and maintenance of exploitative relationships as to trump language, legal institutions, and even the presence of a parliament modeled on Westminster. Markets and international trade do not trump dysfunctional institutions designed to permit elites to exploit their poorer neighbors. Stated more boldly, the political markets of pseudo-democracy in Jamaica were more like the authoritarianism of feudalism around them than they were like the British model back home or indeed in North America. If there is the chance for a few to seize power to exploit the many, it is an almost irresistible temptation.

Looking broadly at the Western Hemisphere, the early leaders in immigration were those areas that were richly endowed and thus able to develop specialization and trade. Paradoxically, these early beneficiaries of the Ricardian paradigm of specialization and trade would turn from the initial leaders in economic development to the eventual laggards. Between 1710 and 1820, the islands of the West Indies were the big exporters to the rich European markets, as shown in Table 6.3, while New England lagged in exports per capita as well as in total. While there were many facets to the gradual ascent of the US, and especially the areas north of the Chesapeake, it was the areas with the most meager endowments that eventually took the lead in industrialization. New England became a leader in this process, selected as a model for early development by both John Adams and Thomas Jefferson.

The obvious paradox between limited economic prospects and eventual economic leadership as illustrated by the colonies of the New World is very suggestive for our own times. New England was the black sheep, so far as the early colonists were concerned, with mediocre farmland, rivers of only modest length, and winters that were cold enough to freeze the rivers and lakes and to visit extreme hardship upon households that lacked woodstoves, let alone insulation, central heating, or nearby grocery stores. This undesirable situation showed in the immigration figures of Table 7.3, where net immigration into New England for the first 150 years was negative. It behooved New England to do all it could to attract immigrants and even more to make it as attractive as possible to current inhabitants, a situation opposite to that perceived by the Mexican authorities. Policy in New England was based upon building opportunities in the home markets, particularly through favoring the development of public goods to help open opportunities for all inhabitants. Luckily the US colonies were allowed to elect their own leaders and thus help train the populace to take charge of its own destiny instead of being ruled by "peninsulares" who had borrowed money to buy the offices that would allow them to extract resources from their subjects. Strategies of local development, implemented through institutional choices, such as small plots of land, were articulated by the New England colonies well before they became part of the model for the US as a whole.

New England was a capitalist democracy almost from the outset; while some aspects of this development were due to ideas that colonists brought with them, other aspects were strongly influenced by the hardships that they encountered, as discussed at the beginning of this chapter. Colonists' beliefs in land as property were supplemented by the circumstances of the New England colonies, where land was abundant and there were no feudal holdings to be overthrown. For a very small investment, virtually every family could have an ownership stake in the economy from the outset. A single institutional choice, to avoid the give-away of large parcels to early settlers or other notables, helped build both capitalism and democracy. On the other hand, some of the colonists came to establish model societies based upon communal agriculture, somewhat like the kibbutzim some Israelis would establish in migrating to Palestine-Israel 250–300 years later. Communal agriculture was scrapped almost immediately by Governor William Bradford; it was a political decision taken in order to reduce the risks of starvation. Just over a century later, John Adams and Thomas Jefferson similarly agreed on the importance of widespread possession of land as the basis of support for democracy, and hence on the assurance of access to land by dividing it into small plots. Since the land was not suited by quality or climate for plantation agriculture, it became the basis for family farms that were in fact rain-fed and thus seemingly independent from one another, creating a fortuitous base for voter independence as well as capitalist entrepreneurship.

With its small, independent and largely self-sufficient production units, New England was well-situated to create local government as the basic unit of governance; towns and then cities were able to take responsibility for public goods including roads, schooling, and law enforcement. Relatively equal incomes made it possible to raise money through real estate taxes, and local government spent more than state and federal governments together, except during wartime, until the onset of the Great Depression. Town government was run mostly by elected amateurs; as de Tocqueville noted, it took nineteen American amateurs to do the work of one (appointed) French mayor. However, the ultimate stroke of genius came from Jefferson in the development of the Northwest Ordinance.

As elaborated above, the Northwest Ordinance took the very unusual step, then or since, in awarding mineral rights to the landowner, a feature designed to reduce the powers of government at all levels. This aspect of the Ordinance promoted private rights over those of the public, but in most aspects the effects of the Northwest Ordinance were the reverse; notably, its explicit development of public goods would mark a huge departure from South American practices, then or since. For example, it mandated an official survey of some 400,000 square miles, certainly one of the greatest land development schemes of all time. Congress backed this mandate up by financing the marking of 640-acre plots, thereby establishing an officially sanctioned registry of reference for all such property.[200] The Ordinance was followed, approximately 80 years later, by the Homestead Act, which used a similar scheme to carry it through to the Rocky Mountains. State-financed surveys were a uniquely strong way to establish property rights for people of ordinary means. They had far more to do with US respect for property rights than the squabbles of miners staking their claims in perhaps a few thousand square miles in California and Nevada, an observation

[200] Early markers ranged from man-made wooden stakes and posts to natural markers such as trees, pits, and piles of rock.

that de Soto seems to have overlooked. By abolishing primogeniture and entail, the Act made land more tradable, while giving parents the right to treat their children equally should they so desire. Moreover, following the precedent of the Northwest Ordinance, it set aside 3% of public land to finance public education available to all. State and local governments were thus endowed with incomes based on public property. They were not dependent on higher levels of government for their funds, as in South America, and these differences have endured to the present time. European settlers in South America certainly had plenty of land to effect a similar disposition of it, but much of the population was not entitled to schooling or legal protection.

The Constitution was, of course, the defining piece of legislation in early US history. It established the first operating republic, where the citizenry elected representatives rather than participating directly in legislating for themselves, as the Greek citizens had in their city-states. In addition, it divided government powers among three branches, though it arguably left the judiciary "supreme" in the event of a constitutional confrontation between the Supreme Court and either of the other two branches. This notion of judicial supremacy would not be copied by any of the parliamentary systems abroad, where sovereignty was typically located in the lower house of parliament.[201] Such an unusual grant of power to the Supreme Court would combine with the silence of the Constitution on which level of government had the power to grant corporate charters, a silence that implicitly left chartering powers exclusively to the states. Judicial supremacy and state power in the economic realm together in turn created a defining feature of US capitalism as the largest firms grew more than a thousand-fold in employment between 1800 and 1900, a development discussed at length in Chap. 13.

On the other hand, the powers implicitly granted to the states to regulate intrastate commerce, plus the continued use of the concepts of British common law, meant that state courts could refashion market frameworks to favor producers versus consumers and industry versus farmers, or indeed the status quo. In the Massachusetts Mill Dam Act, as discussed above, the state gave permission for the abrogation of riparian property rights to promote economic development, and other state courts followed Massachusetts precedent. Courts in this way found ways to implicitly subsidize producers without the benefit of a vote by the legislature, a practice similar in effect to enactment of a protective tariff to subsidize firms at the expense of consumers rather than taxpayers. All in all, as Horwitz states, the courts found ways to interpret the laws to make them instruments of economic development through their modification of market frameworks, a practice that would be amplified in the 19th century, as explained in Chap. 13. Markets still reached equilibrium, but playing fields were tilted toward producers almost from Independence.

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[201] This implicit feature of the Constitution would be established by the bold decision of the Court in *Marbury v Madison*, in which the Court established the right to declare Acts of Congress to be unconstitutional.

Taken as a whole, these conclusions suggest the importance of matching a capitalist model to its context and, more strongly, illustrates the developmental advantage a capitalist model wields. The first 200 years of US history were almost an ideal exemplar of what free market capitalism could achieve when competition was among firms the size of atoms, which meant that such firms had virtually no market power, and when markets were truly the supreme institutions for the achievement of coordination. Smith's idealized pin factory would have been a model of a relatively large firm at the time, as well as of the entrepreneurial-developmental side of capitalism, even to the point of the coordination of operations and investment within the firm.

Interestingly, that capitalist model seems not to have been clearly established anywhere in Latin America over its first 300 years. In my view the great US advantage relative to Latin America was much the same as that established in Europe relative to other countries at about the same time, i.e., capitalism. To paraphrase Braudel's wonderful metaphor for the rise of Europe, the "yeast" that allowed the US economy to rise relative to its South American neighbors was none other than that recipe for economic governance that we call capitalism. South American leaders had an abundance of fine ingredients with which to cook, so to speak, and an abundance of oligarchs to try their hands at culinary leadership, but its political leaders were not about to allow the decentralization of economic power to these oligarchs that would permit them the opportunity to experiment with the capitalist recipe. Brazil seems to have made such a change in the 1880s, after independence, and Mexico was probably a bit later.

As I discussed in Chap. 5, the ultimate key to capitalism lies not in its product markets so much as in factor markets, and notably in the willingness of a political authority to permit these factor markets to exist and to function in the first place. The existence of factor markets is, as Eric Jones and other researchers have shown, the sine qua non of capitalism, and factor markets cannot be established except by political decisions. Without political decisions to permit factor markets, and the additional willingness to develop regulatory frameworks to help govern such markets, there can be trade, but no organized commerce in the factor markets. The US case might at first appear to be an exception, because the US enjoyed factor markets virtually from its inception, but this requires one to overlook the institutions of the indigenous inhabitants who were pushed aside by the European settlers or otherwise disposed of. Thus, it was not an exception. The establishment of factor markets followed takeovers by a number of foreign landing parties. It was only much later that these events were celebrated with that famous Thanksgiving turkey.

Once established, the US became an iconic example of political as well as economic decentralization, and for the first 200 years this was the underlying base for a singularly symbiotic combination of democracy and capitalism, both of which were able to develop rapidly and in original ways in their fortuitously egalitarian circumstances. It is indeed ironic that in 1830, or just as de Tocqueville visited the United States, this fortunate symbiosis was about to crumble in the face of the Industrial Revolution. I will examine these fundamentally new circumstances in Chap. 13.

Part III
Political Obstacles to Capitalist Development

Prologue
The Arizona Market: A Case Study in "Nation"-Building

On November 21, 1995, representatives of Serbia, Croatia, Bosnia, and Yugoslavia reached an agreement to end almost 3 years of civil war that had resulted in some 250,000 deaths and about three million displaced persons. The agreement was negotiated and signed in Dayton, Ohio, symbolizing the fact that the United States government was prepared to commit troops to keep the peace if one was agreed upon.

While the most difficult negotiations had been among the representatives of the warring parties, US military and civilian authorities had different views concerning the appropriate role for any military forces that might be sent to Bosnia. US military leaders were emphatic that NATO's mission should be narrowly defined as securing the withdrawal and demobilization of hostile forces and the opening of Bosnia to free movements of goods and persons. Moreover, there was a great deal of pressure from both the Pentagon and Congress to avoid "mission creep" or "nation building." The NATO mission was to provide security or at least an absence of hostilities; and it did not include taking responsibility for the economic and political rebuilding of the nation. In contrast, Richard Holbrooke, Assistant Secretary of State and chief architect of the treaty, argued that the military should undertake additional tasks in support of peace, including keeping roads open, assisting in election processes, and arresting war criminals. In this view, successful accomplishment of implementation force (IFOR) military responsibilities would constitute only one leg of a three-legged stool that included civil and political responsibilities—all of which were required to create peace, stability, and the conditions for reconstruction.[1] The compromise eventually reached between Holbrooke and Joint Chiefs of

[1]James J. Landon, "CIMIC: Civil Military Cooperation," in *Lessons From Bosnia: The IFOR Experience*, ed. Larry Wentz (National Defense University, 1997), 120.

Staff Chairman General Shalikashvili, and agreed to by Secretary of State Warren Christopher, Secretary of Defense William Perry, and National Security Advisor Anthony Lake, gave IFOR the "authority" but not the "obligation" to work toward civilian implementation goals. This left a considerable measure of discretion to local commanders to interpret the implied mission of the IFOR troops. This zone of "commander discretion" in interpreting the mission is crucial to the story that follows.

NATO troops began arriving in Bosnia in the middle of December to take up positions in a mountainous region covered with snow. Among their initial objectives was to monitor and if need be enforce the separation of the warring parties and then to open the roads to the free movement of all sides. Particular attention was focused on the Posavina corridor, a 3–5 kilometer wide strip of land running west to east and separating Croatia from Bosnia. This corridor was the connecting link between the eastern and western segments of the Republika Srbska, and had been the scene of some of the fiercest fighting of the war. Brcko was the key city in the corridor. Formerly a majority Bosniac community, it had been ethnically cleansed by Serbian forces, and Serbs now accounted for 97% of a much-diminished population. There were an estimated 30,000 Serbian armed forces in the corridor as a score of NATO troops arrived in their humvees.

Major General William Nash was Commander of the US sector that included the Posavina. His sector had two major roads, and their junction was a particular focus of concern. The east-west highway through the Posavina corridor had been a vital lifeline for the Serbs, and Nash proceeded to name it Route Texas. The north-south highway, crossing the corridor to connect Croatia on the north with Bosnia, was a severed lifeline for the Croats and the Bosniacs. Nash named this Route Arizona. Since both sides in the war had insisted on control of their respective corridors, and since these demands were mutually incompatible, a special zone of some 500 square kilometers, encompassing Brcko and the highway junction, had been designated to be under direct NATO control, as a protectorate. Its eventual disposition was to be decided at a future time.

Among Nash's first concerns was to see that the Serbian checkpoints along both of these roads were dismantled to permit the free movement of people and commerce. As part of this process, Colonel Gregory Fontenot, his brigade commander for the corridor, was to establish a checkpoint, punctuated by a small armored detachment, on Route Arizona, so that NATO troops could monitor north-south traffic. The times were tense, as the process of separating the forces was just underway and the respective troops still had to be demobilized and their weapons stored and locked up when Fontenot began to observe surprising developments at his checkpoint:

> Within a few days people began to turn up at the checkpoint to meet one another after the years of separation. It was a safe place to gather to meet people from the other side, or even neighbors. And it was not long before people were selling cigarettes and gasoline and peppers. Then a fellow came one day with a van, and he set up a small stand to sell coffee, and that helped attract more people. The next thing we knew we had cars parking along the road, and people congregating, at least during the daytime. Soon the crowds became an

> obstruction for those using the highway. So I called General Nash and asked for permission to clear some space at the edge of the road and put down some gravel, to get the commerce off the highway.
>
> General Nash had to think about the proposal because he knew what I was asking. In order to use the abutting land, either for the commerce or for parking, someone had to clear the land mines. There were thousands of mines in Brcko and NATO forces were forbidden to clear them by the Dayton Treaty. That was up to the Bosniacs, Croats, and Serbs. I planned to coordinate the mine clearing with their help. A bit later, General Nash called back and said, 'Okay Greg, but be careful.' In addition, he gave the OK to use some of his budget for gravel, so we could stay out of the mud. Next thing you know small stands began to appear, where people were selling things, and there was again a shortage of space, and the need to clear more mines and add gravel. The budget and the mine clearing were justified as necessary to keep the highway open for vital supplies, not as a way to promote a local flea market.
>
> Of course, we were providing security in this very small area. We were searching all of the cars and disarming anyone who wanted to participate in the market. As the market grew, the locals began to sell all sorts of things, like a flea market. Soon our troops had to take steps to prevent shakedowns by nearby police and to stop a string of car-jackings in the area. So I made a deal with Mijo Anic, a local Croat mayor, to oversee the market and regulate what went on there. It was up to him to rent out space, at so much a square meter, and also to keep order. There was a remarkable growth in the variety of things sold, to include refrigerators and livestock, some of it brought long distances. Some of the trade was pretty unsavory, but unregulated capitalism is a pretty rude sort of activity. By 1997, one source estimated that the market was doing about 100,000DM per day.[2]

The wide spot in the road soon came to be known as the Arizona Market, and it grew rapidly despite its isolated rural location. It enjoyed some important political as well as economic advantages. NATO troops and armor provided an overall assurance of security, even though the police forces were made up of the former warring parties. Space was rented by the square meter, in very small parcels (about three square meters), and at reasonable rates. There were no taxes on sales or value added. In effect the Arizona Market became a low tax, free trade zone under the guardianship of the local NATO commanders. It had no official status either in the Dayton Agreement or in subsequent documents over the next several years.

The status of the Market, though informal, was vitally important because local politicians sometimes charged extortionate taxes on local trade. Local political leaders could grant reductions on the basis of political loyalty. High local taxes, backed by the coercive powers of a police force, were a vital source of potential revenue and thus power for local political bosses. The Arizona Market was a threat to the incomes of nearby political bosses as well as a source of political power for its overseer, Anic. It was also a model of private enterprise capitalism in a land where unemployment was estimated to be about 50% and lawlessness the norm. In the Market, trade was free and untaxed by local power brokers, and personal safety was assured.

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[2]Colonel Greg Fontenot, interview, April 8, 2004, quoted in Bruce R. Scott and Edward N. Murphy, *Brcko and the Arizona Market*, Harvard Business School Case 9-905-411.

In 1997 a US foreign service officer arrived in Brcko to serve as the "viceroy" of this tiny but sensitive enclave. Colonel James Warner, Brigade Commander for the Posavina area in 1998, noted that he had heard from the Foreign Service officer a number of times during his tour in Bosnia, often because local mayors had asked the latter to have the market shut down. "When he called, the foreign service officer would usually point out that unsavory things were taking place in the market, and that a different form of control was needed. Every time this happened I would go for an inspection with my boss, Major General Larry Ellis. We always found that the claims of misdeeds were exaggerated and we would take no action. At one point, after an unannounced inspection, General Ellis remarked that the place looked like a cross between a Home Depot and a flea market, and it stayed open."[3]

The exact location of the checkpoint was a crucial element in the remarkable fortunes of the Arizona Market. The checkpoint had been located in the Zone of Separation, a narrow strip of land separating the warring sides, and a piece of land that had been placed directly under the control of the US Defense Department, not NATO and not the State Department. Temporary sovereignty rested with the Defense Department and in effect this sovereignty was exercised by the local Commander of the American zone, and initially by General Nash.

At one point in the summer of 1998, the tensions over control of the market escalated when Colonel Warner received a tip from Sarajevo that the Bosnian president would be sending about thirty police the following day to take control of the market. After checking with General Ellis, Warner assigned a detachment of troops to be there first thing the next morning to protect the market. The following day, when the police drove up, they were greeted by a company of armed troops and some armored vehicles. The police were advised that their help was not needed and that they should probably return to Sarajevo, which they did.[4]

By 2001 the Arizona Market had grown from its small, informal start along the road side to an organized market with over a thousand stalls covering an estimated 300 acres and doing roughly $100 million per year in sales. It had also become a point of interest to a major Italian property developer who planned to invest $100 million or so to expand and upgrade the market into a shopping mall. General Nash paid a visit to the Market in 2004, when he was in Bosnia to mark the end of the mission of the US troops in that zone. Upon his return he reported: "There are now an estimated 2,500 stalls, the neon sign for the Market is about a hundred feet tall, and some people claim that it is the biggest shopping mall in the Balkans. We certainly never imagined anything like this when we began to add a bit of gravel at the checkpoint."[5]

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[3] Colonel James Warner, casewriter interview, April 2004, quoted in Scott and Murphy, *Brcko and the Arizona Market*.

[4] Ibid.

[5] William Nash, casewriter interview, June 30, 2004, quoted in Scott and Murphy, *Brcko and the Arizona Market*.

What were the lessons to be drawn from this example of spontaneous development? For the military commanders on the scene, one of the lessons that stood out was the fundamental importance of security to the conduct of commerce or indeed the existence of any real freedom of movement or speech. There could be no real freedom or private enterprise without security.

A second lesson was that reestablishing order was a labor-intensive business. Even in 2004 the Arizona Market existed as an island of development in a sea of disorder and economic stagnation. NATO simply did not have the troop strength to bring safety to the Bosniacs when they went home to their villages, and especially not at night. It could create an island of safety and facilitate development in a small enclave, but even 60,000 troops were not remotely enough to bring personal security to the population of Bosnia, a multiethnic state about the size of Connecticut.[6]

Third, peace and quiet was not the same as law and order. Law and order required that the political authorities have a monopoly of coercive power, and that this power would be used in accordance with the law. In Bosnia, private citizens could intimidate one another without fighting out in the open. Powerful patrons could intimidate weaker neighbors, and there was not much that NATO could do about it. Policing was up to the local police. NATO troops could put a quick end to large-scale violence but were forbidden to take up police duties and indeed lacked the manpower to do so effectively.

The Arizona Market was not nurtured by minimalist government. It existed and flourished because a few senior officers, on their own initiative, took personal responsibility to use the troops and guns under their command to see that there was law and order in a small area such that buyers and sellers were physically safe while transacting their business, including while coming to and going from the market. The officers involved took on these added responsibilities because they believed that it was right for the Bosnians that they do so, and thus their implied, if not their official, mission. They did so at some risk to their careers, as any mistakes in such nation building efforts would invite unfavorable publicity in some segments of the US press.

Ironically one of the keys to the success of the Arizona Market lay in ambiguities of the Dayton Treaty, which permitted but did not require NATO troops to be involved in nation building and which awarded the Zone of Separation to the control of the Department of Defense, and without setting a specific time limit. So NATO troops had the power to act as a sovereign authority within the Zone of Separation for several years, by which time the Market was not only a commercial hub but also a major source of local employment and thus too big to be shut down. In this case sovereignty was used to good effect by unelected military officials who saw their facilitating economic development as a contribution to their mission to help establish security and stability in Bosnia.

The Arizona Market experience, if properly understood, sheds light on the enduring, and still unanswered, questions of development: Why do billions of people

[6] Warner, quoted in Ibid.

remain mired in poverty in an increasingly globalized, affluent world? Why are so many states blighted by corruption, instability, and misrule, despite the best efforts of local reformers and the international community? What are the political and institutional underpinnings of stable, well-functioning markets? And what combination of political will, popular mobilization, institutional design, and economic reform is needed for successful development? These questions help shape and guide the narrative and analysis of this book.

One Country, Two Systems

Political islands called states, whether successful or not, all share a very important attribute, i.e., sovereignty. The so-called developing states in the global economy have within their borders profound disconnects much like those between the Arizona Market and the remainder of Bosnia. Parts of Bosnia have been unable to integrate back into a coherent whole despite their common history, common language, and similar formal government. Local differences in culture, institutions, and political processes limit the reestablishment of an integrated state in spite of the rebuilding of the roads and other infrastructure. In like manner, the global village may be open to free trade, but the various political units are profoundly different from one another in the extent to which their institutions allow them to take advantage of the expanded markets that are available on their doorsteps. Liberated markets create new opportunities, but they are of limited value to societies that remain crippled by dysfunctional institutions and especially by governments that lack the capacity and/or the will to provide security for their inhabitants. In addition, many governments lack the entrepreneurial capabilities to mobilize the requisite political power to reform their institutions.

In Part II I studied the emergence of capitalism in three very different settings and found entrenched institutional and political resistance to change in two of the three, i.e., in Europe in the formative years 1400–1800 and in Latin America in the period 1500–1800. The US was the exception, owing to the congruence of its two decentralized economic and political systems.

In Part III I explore barriers to development in two industrialized countries in order to show that developing countries have no monopoly on such problems. As in Part II, I rely upon in-depth case studies to illustrate my argument that market forces cannot be expected to overcome entrenched institutional barriers. Each of the two country cases I chose has a region that has performed poorly and has failed to converge toward neighboring regions in a developed market economy.

The two case studies are based upon a north-south regional comparison. The first case is on Italy, and the second is on the United States. In Italy, the lagging area has been and remains the Mezzogiorno, an area south of Rome that comprises almost one-third of the country. Since the 1950s, the Mezzogiorno has been the recipient of a panoply of programs to try to bring about its convergence toward northern levels, thus far without clear success. In the US, the lagging area was the former

Confederate States. This second case is particularly valuable because, after falling behind by 1880, the South failed to converge until 1940 in spite of a Civil War and a 12-year military occupation designed to unify the northern and southern systems economically, socially, and especially politically. Then, from 1940 onward, the South made remarkable progress toward convergence, first in terms of incomes and later in terms of its institutions. The US case permits us to ask three very important questions: (1) Why did southern incomes fall behind those in the north before the Civil War?; (2) Why did they fail to converge between 1880 and 1940?; and (3) Why has there been successful convergence since then?

My argument, when analyzing the case of Italy in Chap. 8 and that of the US in Chap. 9, is that the essential causes of income divergence for the low performing regions in these two rich countries were much the same as those identified in the case of colonial Latin America relative to the US in Chaps. 6 and 7. When addressing the circumstance of the US in particular, I argue that the convergence of southern incomes in the 1940s was due to unusual circumstances associated with World War II, while the continued convergence after 1950 was largely attributable to the sustained application of political force by the federal government on a scale and for a duration not normally possible in most domestic contexts. In each of these case studies I draw upon the analyses of recognized experts to explore the complex causality of retarded economic development in one region relative to its neighbor, despite the exposure of both to market forces.

There are three standard explanations for low-performing regions in industrial countries: one economic, rooted in the decline of a dominant industry within a region; one sociological, rooted in culture; and one political, rooted in a state that fails to provide an adequate supply of public goods such as physical infrastructure, law and order, and broad-based educational opportunities. While academic specialists tend to argue the relative merits of each, debating whether the shocks of a declining industry, cultural norms, or political circumstances best explain the situation at hand, I find merit in all three lines of analysis. Indeed, sometimes two of them merge. For example, overcoming political obstacles to development seems to require societal demands for reform (i.e., public protests in the streets as well as at the ballot box), in addition to mobilization of the power of the state to compel institutional reform.

While recognizing all three of the above as possible sources of internal failures to achieve convergence, I believe that the political causes are the most important. The political argument hinges on the existence of patron–client relationships where one person or group has extralegal powers over others, a situation outlined in Chap. 4. While some scholars, such as Robert Putnam, consider patron–client relationships to be cultural, I consider them to be primarily political. Putnam argues that "institutions shape politics" and "institutions are shaped by history."[7] I would argue, however, that institutions are shaped by political power in a three-level system, as illustrated

[7] Robert D. Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, NJ: Princeton University Press, 1993), 7–8.

in Fig. 2.2. Political institutions are created and/or shaped in large measure by the fact that one individual or group has the power to persuade government to induce or compel particular behaviors from other persons or groups. This chapter aims to explain just how this has worked in two important case studies, one in Italy and the other in the United States. In both of these examples, some people had far more power than is implied by horizontal or egalitarian relationships and were, and in the Italian case still are, able to exercise their power both through legal and extralegal means.

In their most benign form, patrons may amass power by helping their clients with small favors, such as fixing a parking ticket or expediting a permit. Patrons may also be a means to securing jobs (i.e., literal patronage), disability benefits, or other sources of income from the state. In addition, patrons often have the power to punish, not just through withholding favors, but also through physical intimidation and, in the extreme, through arranging for bodily harm. The existence of patron–client relationships implies that legal protections are uneven, with powerful patrons enjoying extralegal means of rewarding and punishing their clients while enjoying more protection from such pressures than their clients. If their clients behave in subservient ways, it is not so much due to lethargy or habit as to the recognition that the patron has the power to reward and to punish them in a variety of ways. Clients may learn subservience, aware that they will be severely punished if they fail to submit to their patron's wishes. The cultural habit of subservience is acquired for self-protection or advancement, through involuntary acquiescence.

The existence of patron–client relationships is a symptom of weak, deliberately selective, and/or abusive law enforcement. It is often similarly accompanied by selective and thus distorted provision of infrastructure and education as well. In this way, patron–client relationships exist as part of a system characterized by distorted institutions designed to benefit the few at the expense of the many. My argument in the next two chapters is that some regions can have deliberately distorted and/or biased institutions that cause them to have distorted, partially dysfunctional, and thus underperforming markets. I also argue that, in a democracy, society must demand changes in political and regulatory relationships if these vertical, power-based relationships are to be reformed. Merely providing a supply of good laws and/or institutions is likely to be of little avail, as was the case in Eastern European countries in the post-Soviet era reforms.[8]

Overall, I argue that these case studies, and especially that of the Mezzogiorno, are suggestive of the causes behind the broader convergence failures found among developing countries. The US example is uniquely valuable because it suggests how much political power is required to overcome the institutional barriers that can be entrenched even in a nominally democratic system. Given the continued affirmation of segregation in the US South from 1860 until 1965, this example further suggests that market forces are not likely to be adequate to bring about convergence for most developing countries in most circumstances. Their convergence will instead depend

[8] See, for example, the writings of Katharina Pistor on reform in Eastern Europe.

upon far-reaching institutional reforms, which in turn depend upon the mobilization of political more than economic power, a difference illustrated by the eventually successful reforms in the United States after 1960. The case of Italy confirms this conclusion; its failure to mobilize comparable amounts of power in a sustained way has left Italy without a solution for its underperforming Mezzogiorno for more than a century, with no reason to believe that significant change is on the immediate horizon.

Chapter 8
Italy as "One Country, Two Systems"

Co-authored by Jamie Matthews

Italy, like Germany, was late to achieve political and economic unification, doing so only in 1860, and its incomes lagged behind those of its west European neighbors as recently as 1950. From a broad perspective, Italy serves as an example of how a unified country with relatively developed institutions can take advantage of the opportunities provided by a larger market to converge toward the income level of its richer partners. Its accession to the Common Market in 1958 led to a decade of per capita growth of more than 6% per year in what was referred to at the time as the Italian "miracle." By 1990, Italy's per capita GDP was ahead of Britain's and comparable to France's.[1]

Yet, from a narrower perspective, Italy is an example of how two historically distinct regions, the North and the South, could experience a failure of income convergence for more than a century, even though they remain part of one and the same national economy. The Mezzogiorno, which is roughly the one-third of Italy south of Rome, briefly experienced a modest convergence with the richer regions to the North in the 1960s, only to slip backward again from the mid-1970s onward. Why would incomes in the Mezzogiorno diverge from those in the North when the two regions were part of the same economy?

The first thing to note is that Italy's economic performance on the whole has not been all that it has seemed to be, and the underlying reasons have a lot to do with history, politics, and corruption. From the end of World War II until the 1990s, Italy had the strongest Communist Party in Western Europe. As a precaution against ceding undue power to regions with Communist majorities, Italy was nominally organized as a unitary state with power concentrated in Rome. At the same time, the Italian state was effectively organized as a weak entity to safeguard against the type of abuses suffered during the fascist regime of Benito Mussolini. For instance, parliamentary seats were allotted on the basis of proportional representation to prevent the

[1] However, it should be noted that much of this growth was fuelled by public spending, resulting in an increase in public debt from 60% of GDP in 1960 to 120% in 1993 (Consolidated gross debt of central government as reported in European Commission, *European Economy* 70/2000 (Luxembourg: Office for Official Publications of the European Communities, 2000), Annex Table 80).

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_8,

domination of a single party. The power of the state suffered further when, immediately after World War II, the Christian Democratic Party made an informal alliance with the Mafia in order to prevent the left from dominating the South;[2] this deal ensured that successive Christian Democratic governments would provide political cover for a criminal enterprise based in the South. Moreover, elaborate judicial safeguards were set up to protect those accused of crimes in order to guard against the excesses of the fascist era, further empowering criminals and weakening the state. Meanwhile, as part of a Cold War strategy, the Communists, although the strongest such party in Western Europe, were completely excluded from power. Italian governments lasted on average about 12 months; though highly centralized, the state was nonetheless very weak. In the analysis that follows, I will argue that this weak Italian state played a major role in the underperformance of the Italian South.[3]

Notably more powerful than the Italian state were Italian labor organizations. In fact, Italian unions were among the strongest and most militant in Europe, thus making up an important part of the political as well as economic context. A general strike could bring down a government, and strike threats helped propel wages to unusual levels. From 1960 until 1976, employee compensation in Italy took a higher share of GDP than in France and almost 5% more than in Germany.[4] This left correspondingly less revenue for profits, investment, and modernization. In addition to demanding high wages, the unions were strong enough to block the downsizing of the labor force that would be needed to boost productivity growth. From the 1970s onward, Italy's economic performance was average at best among its neighbors, as it borrowed to finance generous public expenditures, especially pensions. When the EU began to impose fiscal discipline in the 1990s, its performance fell well below the European average.

Further and much more pivotal pressure came from left-wing political forces. Italy, like France and Germany, was affected by an upsurge of left-wing violence in the late 1960s, including a string of knee-cappings and assassinations. In 1976, Prime Minister Aldo Moro negotiated a "historic compromise" with the Communists, hoping to bring them into the political process and thereby reduce some of the violence. Shortly thereafter he was kidnapped, held for ransom, and assassinated when the government refused to bargain for his release. His murder changed the political and economic equation in many ways.[5]

First, revulsion at the violence turned the public against the unions and their strikes. With this change, wages as a share of GDP began to decline from their peak. At much the same time, the Socialists were brought into the government and thus

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[2] Alexander Stille, *Excellent Cadavers: The Mafia and the Death of the First Italian Republic* (New York: Vintage Books, 1995), 18–19.

[3] This summary is based on Bruce R. Scott and Jamie R. Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," Harvard Business School Case No. 702-096.

[4] Based upon European Commission, *European Economy* 69/1999 (Luxembourg: Office for Official Publications of the European Communities, 1999), 312.

[5] This analysis, like much of this section, has been condensed from Scott and Matthews, "One Country, Two Systems (A)," Revised August 12, 2002.

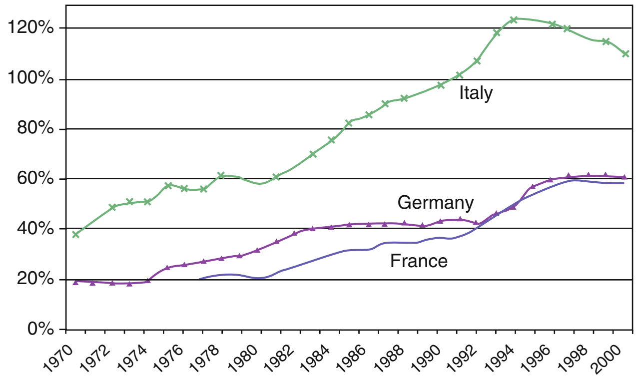

Fig. 8.1 Consolidated gross government debt, 1970–2000 (% GDP, market prices). Note: 1970–1991: West Germany. Source: Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. © 2002 by the President and Fellows of Harvard College. Reprinted by permission. Adapted from European Commission, *European Economy* No. 70/2000 (Luxembourg: Office for Official Publications of the European Communities, 2000), Statistical Annex, Table 80. Previously published in Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. Copyright © 2002 by the President and Fellows of Harvard College. Reprinted by permission

into active competition for political patronage. Parliament passed new legislation creating the *cassa integrazione* to finance early retirement, thereby facilitating the layoffs at and restructuring of the major firms. The *cassa* wasn't really a solution to Italy's economic problems, however; rather, it was a way to shift the cost of redundant employees off of corporate payrolls and onto the state's retirement rolls. As this happened, Italy's pension and patronage obligations ballooned, with Italian government debt rising from 60% of GDP in 1976 to 120% in 1993, a position twice that permitted by the European Union (Fig. 8.1). Pensions and government jobs facilitated the creation of patronage regimes financed by debt, with the Socialists vying with the Christian Democrats for a share of the spoils.

In this way, Italy's apparent convergence toward the EU median income was based in considerable measure on unsustainable policies. At the same time, Italy's overall performance masked sharp regional differences. In contrast to the rapidly-industrializing, high-income North, the Mezzogiorno remained economically backward, with per capita income and productivity levels significantly below those of the North and actually falling further in relative terms from the 1970s onward (see Table 8.1).[6]

How could the Mezzogiorno experience income divergence in an economy characterized by free movement of labor and capital as well as of goods and services, not

[6]This picture was nuanced somewhat by the fact that the province of Abruzzo was achieving income convergence with the Center-North at the same time that the remainder of the region was falling further behind. The reasons for this are discussed later in the chapter.

Table 8.1 GDP per capita in relative terms, North versus South, 1860–1995

	1860	1911	1952	1975	1985	1995
North	100	100	100	100	100	100
South	80–85	50	60–65	65	60	56

Note: Data are rough estimates, particularly in early years
Sources: 1860–1911: Robert D. Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton: Princeton University Press, 1993), 158; 1952: Derived from graph in Rodolfo Helg, Giovanni Peri, and Gianfranco Viesti, "Abruzzo and Sicily: Catching up and Lagging behind," *EIB Papers* 5.1 (2000), 71; 1975–1995: Adapted from Andrea Ichino and Giovanni Maggi, "Work Environment and Individual Background: Explaining Regional Shirking Differentials in a Large Italian Firm," *The Quarterly Journal of Economics* 115 (3) (August 2000), 1064

to mention a single currency, language, legal system, and set of formal institutions? In the following sections, I outline briefly the Mezzogiorno's economic history and contrast it with the relative development success of the Abruzzo (the northernmost province of this region). I then examine a number of explanations that have been offered for the South's relative economic backwardness, before offering my own observations on this issue.

The Economics and Politics of the Divergence of the Mezzogiorno

Northern Italians are fond of saying that the Third World starts south of Rome. An examination of life in the Mezzogiorno shows that there is some truth to this politically incorrect observation. At the end of World War II, the Mezzogiorno was considered the largest under-developed territory in Europe. Agriculture still accounted for more than half of total employment, more than a quarter of the population was illiterate, and only a quarter of the houses had inside plumbing.[7] While the Mezzogiorno's incomes still rose in tandem with those of the North in the early post-WWII period, the region's GDP per capita fell from 65% of the northern average in 1975 to 56% 20 years later, a figure that, if anything, understates the degree of southern divergence. In 1995, the South's unemployment rate (at 19.2%) was three times that of the North, and its labor force participation rate was only 35% compared to 45% in the North.[8] This is all the more remarkable considering that public sector employment in the South was almost twice that in the North, or 13% of total employment versus 6%.[9] If one were to correct for padded public payrolls, the total incomes earned in the South were arguably less than half those in the North.

[7]Rodolfo Helg, Giovanni Peri, and Gianfranco Viesti, "Abruzzo and Sicily: Catching up and Lagging behind," *EIB Papers* 5, no. 1 (2000): 61.
[8]Scott and Matthews, "One Country, Two Systems (A)," 23, exhibit 14.
[9]Ibid., 23, exhibit 13.

Social and financial indicators were just as telling. For instance, the South's murder rate was twice that of the North's, and the value of bad debts carried by its banks as a proportion of lending was significantly higher.[10] In addition, the South was and continues to be a center for illegal economic activity, accounting in 2002 for the majority of the country's black market, an estimated 27% of the country's formal GDP; this places Italy second only to Greece in the EU.[11] Thus, in all these respects, the Mezzogiorno can be considered a Third World variant of the Italian miracle.

Like many developing countries, the Mezzogiorno had a higher birth rate and a tradition of emigration in search of better jobs than its richer neighboring area. Emigration from the Mezzogiorno approached 2% of the population annually in the years just before and after 1900.[12] It resumed after World War II, with an outflow of more than two million people between 1952 and 1961, but by the 1990s it had all but ceased.[13] As a result, the population in the Mezzogiorno grew from 19 to 21 million people between 1975 and 1995, while that in the North remained unchanged at 36 million.[14]

The poor economic performance of the Mezzogiorno is all the more remarkable when we consider the succession of development plans devised for it. The region's relative economic backwardness after World War II was a principal reason for the creation of the European Investment Bank (EIB) at the time.[15] Over the ensuing years, Rome implemented a range of regional strategies. First, in the 1950s, there was state funding of infrastructure to improve road and rail connections between the South and the North. Then in the 1960s, industrial policy was tried, with incentives as well as bureaucratic pressure for a number of large, state-owned enterprises to construct new facilities in the South (led by a large steel plant at Taranto, at the heel of the boot). In the 1970s, a series of regional reforms were implemented and promised continuing economic growth through continuously rising public sector debt throughout the 1980s. Moreover, there was a shift toward transfer payments and public employment, though these public expenditures were part of a corrupt system of vote-buying that was financed by the central government. Power thus began to be decentralized to the regions in the 1970s, although it remained more a matter of form than substance. But in spite of these varied regional development efforts, the Mezzogiorno continued to fall even further behind. How could this be?

The increasing income divergence was not because the South was suffering the pangs of the closure of obsolete industries, as was common in some depressed areas of Belgium, Britain, and France; the South had experienced little industrialization

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[10] Andrea Ichino and Giovanni Maggi, "Work Environment and Individual Background: Explaining Regional Shirking Differentials in a Large Italian Firm," *The Quarterly Journal of Economics* 115, no. 3 (August 2000): 1064.

[11] "A Nastase Shock for NATO?" *The Economist*, April 4, 2002.

[12] Gustav Schachter, *The Italian South: Economic Development in Mediterranean Europe* (New York: Random House, 1965), 32.

[13] Helg et al., "Abruzzo and Sicily," 64.

[14] Scott and Matthews, "One Country, Two Systems (A)," 23, exhibit 14.

[15] Helg et al., "Abruzzo and Sicily," 61.

Table 8.2 Gross fixed investment as a percentage of own GDP

1951		1961		1971		1975	
South	North-Center	South	North-Center	South	North-Center	South	North-Center
7.1	17.8	25.1	22.0	28.5	17.6	28.9	20.8

Source: Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. © 2002 by the President and Fellows of Harvard College. Reprinted by permission. Adapted from Gisele Podbielski, *Twenty Five Years of Special Action for the Development of Southern Italy* (Rome: Giuffré, 1978), 109. Previously published in Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. Copyright © 2002 by the President and Fellows of Harvard College. Reprinted by permission.

until after World War II. Nor was it because the South was investing a smaller share of its GDP; on the contrary, from the late 1950s through the 1980s, investment in the South had consistently exceeded that in the North, at least as shares of their respective GDPs (Table 8.2). Indeed, for a brief period, from 1960 until 1975, this higher rate of investment was associated with a modest degree of income convergence.

The South continued to invest a higher fraction of its GDP all through the 1980s (Fig. 8.2), while again falling further behind. Thus, unlike many Third World countries, the Mezzogiorno could not blame its post-World War II lag on market barriers in the North (including barriers to the movement of people), a low rate of investment relative to GDP, or indeed neglect by its Northern benefactor. What could it blame,

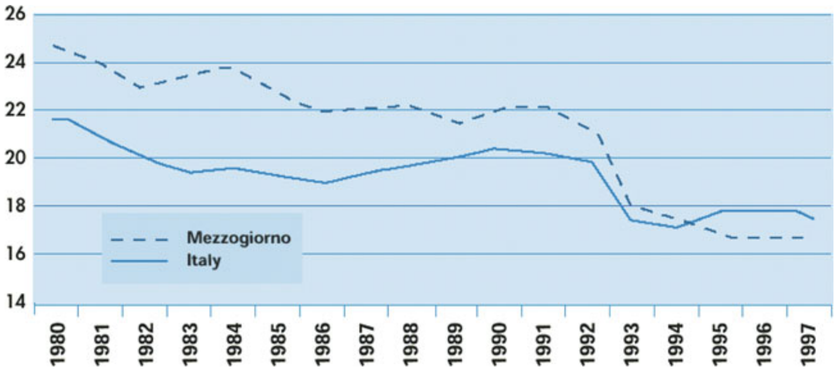

Fig. 8.2 Gross fixed investment as a percentage of own GDP. Source: Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. © 2002 by the President and Fellows of Harvard College. Reprinted by permission. Originally published as Helg, Peri, and Viesti, "Abruzzo and Sicily: Catching up and Lagging behind," *EIB Papers*, Vol. 5, No. 1, 2000, 67. Previously published in Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (A)," case no. 702-096, Boston: Harvard Business School 2002. Copyright © 2002 by the President and Fellows of Harvard College. Reprinted by permission

then? The answer can be found by studying performance not at the level of the region but rather at the level of its provinces. Performance within the Mezzogiorno was not uniform, and the performance of one province helps shed light on the difficulties of the remainder.

Abruzzo, "The Province That Could"

In the early 1950s, Abruzzo was a "full member" of the underdeveloped South, with "little industry, few natural resources, poor transport infrastructure, high agricultural employment and a low standard of living."[16] Over the next 50 years, Abruzzo's industry sector grew twice as rapidly as that of Sicily (a province with a similar economic profile in 1950); in fact, for three of these five decades, it was the fastest-growing province in the country. Incomes in the Abruzzo converged strongly with those in the more prosperous Center-North, with the income gap closing to half of what it was by 2000 (in contrast to Sicily, which made minimal gains).[17]

Helg, Peri, and Viesti, in their study for the European Investment Bank, attribute the superior performance of Abruzzo to a combination of geographic, institutional, and cultural advantages. They emphasize several factors, some inherited and others the result of policy changes. As the northernmost region of the Mezzogiorno, Abruzzo benefited from its proximity to the North's dynamic markets, an advantage that was reinforced with the construction of a highway linking it (and the rest of the Mezzogiorno) directly to Rome and the North. In addition, and like other parts of the South, Abruzzo gained from a range of economic initiatives aimed at the southern region in particular, including investment incentives, transfer payments, and a competitive wage scale compared to the North (wages were about 10% lower than implied by North-South productivity differences).[18] But more telling, perhaps, were Abruzzo's specific advantages. Since it had no natural harbors, it failed to attract any large-scale, state-owned heavy industry such as steel or chemicals. As we shall see below, these industries proved to be more of a burden than a benefit for other parts of the Mezzogiorno. The final advantage of the province, as pointed out by Helg, Peri, and Viesti, is that Abruzzo was not home to one of Italy's three entrenched mafia families; all three were farther south in the Mezzogiorno.

As a consequence of these advantages, Abruzzo developed a different industrial structure than its southern counterparts, one based on initially subsidized factories in mechanical engineering and transport equipment. These lighter industries induced the development of new clusters of supporting industries made up of subcontractors, a pattern similar to that farther north and quite different from the provinces further south (where larger scale industry did not generate the same spinoffs). At the same time, Abruzzo's firms benefited from investments in technology; by 1992

[16] Ibid.

[17] Ibid.

[18] Ibid., 61–63.

Abruzzo was spending almost 50% more per worker on research and development than Sicily.[19] As a result, when, by virtue of union bargaining beginning in the late 1970s, wages in the Mezzogiorno were forced upward toward northern levels, Abruzzo's economy was better positioned to afford the increases than the economies of provinces elsewhere in the South.

In addition to purely economic factors, analysts have identified certain broader political and social advantages that Abruzzo enjoyed (and continues to enjoy) over the rest of Mezzogiorno. Abruzzo's relatively lower reliance on state subsidies (because of its healthier industrial sector) and smaller population of government employees have limited its exposure to corruption, a debilitating problem in other parts of the South. And, as mentioned above, Abruzzo was not home to a Mafia family, meaning its traditional patron–client relationships took on less destructive forms, freeing its small- and medium-sized businesses from the worst excesses of extortion and dependency.

This discussion is not meant to provide a definitive account of Abruzzo's relative economic success. My intention merely has been to flag the range of factors—economic, social, and political—that may help explain varying regional patterns of economic development and their persistence over time. A key insight, which I will return to later, is that these factors interact in powerful ways, reinforcing each other's individual effects. With the unique experience of Abruzzo (and its supporting advantages) in mind, I now return to the Mezzogiorno as a whole and consider a number of possible explanations for its economic backwardness. My main focus will be on influential non-economic explanations offered by Robert Putnam and other political scientists. However, I begin with a brief account of the Mezzogiorno's poor economic record.

The Mezzogiorno: The Region That Couldn't

Poorly conceived economic policies have played an important role in the Mezzorgiorno's post-World War II economic history. As I pointed out earlier, in the 1960s, state-owned enterprises were encouraged to build large plants in the South. While this provided some short-term economic stimulus, the short-term gains were outweighed by significant and costly long-term distortions and rigidities. For instance, the state-owned firms were typically unresponsive to market forces and did little to induce the growth of small- and medium-sized suppliers or to build local skills. When economic growth slowed in the 1970s, state-owned firms continued to increase employment, shifting costs to the government budget.[20]

The Mezzogiorno's problems of industry structure were then exacerbated by a very unfortunate decision by the unions to insist on wage parity with the North in the 1960s. While the state could again pick up the tab for state-owned enterprises,

[19] Ibid., 75.

[20] See Scott and Matthews, "One Country, Two Systems."

the private sector firms had to bear the full burdens of non-competitive labor costs. Inevitably, profit margins and incentives to invest suffered.

Efforts to counteract these distortions only reinforced them; government subsidies for increasingly uncompetitive firms succeeded only in keeping them alive, not in building competitive capabilities or promoting restructuring. Like the situation that would develop in East Germany in the 1990s, the failure to maintain realistic labor costs would create a form of dependency, i.e., firms became reliant upon increasing public subsidies for their survival.[21] By the late 1990s, this left the South badly exposed to the fiscal retrenchment that Italy was required to implement under the European Union's stability pact.[22]

Some of the reasons for the Mezzogiorno's development lag were economic: an unfortunate industrial structure, excessive wages relative to productivity levels, and then the receipt of transfer payments that supported dependency more than healthy entrepreneurship. Though important, these economic problems were only part of the story. A number of influential social scientists have drawn attention to wider cultural, institutional, and political forces. Implicit in this alternative approach is the view that economic analysis, by itself, cannot account for the depth and persistence of this region's backwardness.

Culture and Social Capital

Robert Putnam, in a remarkable book called *Making Democracy Work*, makes a strong case for the role of culture in the continuing backwardness of the Mezzogiorno. Put simply, he argues that the South's culture is marked by an acute shortage of social capital, i.e., trust, social norms, and networks that encourage broad social cooperation and collective action.[23] This shortage triggers and is, in turn, exacerbated by a range of anti-social behaviors, including shirking, exploitation, and disorder. This Hobbesian social equilibrium, according to Putnam, has hampered cooperation and undermined the effectiveness of institutions in the South, both economic and political.[24]

Putnam explains how the South's cultural norms have interacted with the region's traditional networks of hierarchical, patron–client relationships. Examples include landowners with tenant farmers as well as owners of small farms or businesses who look to local notables for political protection and economic favors. These vertical relationships in the culture of the Mezzogiono provided the foundation for communities characterized by the anti-social values and behaviors Putnam emphasizes. Given the importance of these vertical, patron–client relationships, people concluded that it was beyond their power as individuals to create the horizontal

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21 Helg et al., "Abruzzo and Sicily," 64–65.

22 Under this pact, Italy and other European Union members were required to bring their public sector debt levels down to 60% of GDP (or below).

23 Putnam, *Making Democracy Work*, 177, 181.

24 Ibid.

relationships of a more cooperative community. Thus, it would be irrational to trust anyone or to try to escape from the protection (albeit oppressive) offered by patrons.

Putnam contrasts the South's civic traditions with those of Northern Italy. He points out that the North tended toward horizontal relationships characterized by high levels of cooperation, trust, reciprocity, civic engagement, and concern for collective well-being. Markets, in this perspective, were characterized by horizontal relationships, so long as no individual firms had monopoly powers. Thus, individuals and small firms acting in markets in the North had primarily horizontal relationships, as did civic organizations supported by volunteers. Life in the North was influenced in considerable measure by civic norms that recognized a notion of public good as well as individual interest; one person could trust another to accept certain civic responsibilities. Putnam called this a culture based on a norm of "brave reciprocity." Since there was a high level of acceptance of this norm, deviants could expect societal punishment in the form of neighborly disapproval or, at the extreme, ostracism. Brave reciprocity thus received continual reinforcement, sustaining a high social capital equilibrium associated with stronger social cooperation and more effective civic institutions than would otherwise exist.[25]

How does social capital affect economic performance? Putnam emphasizes that differences in civic traditions between the South and the North do not themselves explain their contrasting economic records. He freely concedes, for example, that the North's rapid economic development over the past century "was occasioned by changes in the broader national, international and technological environment."[26] But civic traditions do shed light, he suggests, on why the North was much better positioned to respond to market opportunities than the Mezzogiorno.[27] And they also help explain why the South could continually fall farther behind, even though southerners had the right to emigrate to the North.

Whereas socioeconomic development was roughly equal in the North and South in the years leading up to 1900, the levels of civic engagement were systematically higher in the North than the South. The southern province of Abruzzo was not so much an exception as the borderline case. It was the southern province with the highest rankings on civic engagement on each of Putnam's indicators, and it typically ranked close to the lowest ranking northern province.

By the 1970s, socioeconomic development was higher in the North, as was civic involvement. Table 8.3 shows that while the percentage of industrial employment increased in Italy as a whole from 1901 to 1977, this percentage remained constant in Calabria, a southern region. But significant improvement showed in the North; for instance, Emilia-Romana, a northern province, had come from far behind to pass Calabria as an industrial region, a fact consistent with the cultural explanation and not with the explanation based on initial advantages in industrialization and modernization.

[25] Ibid., 162, 177.
[26] Ibid., 159.
[27] Ibid.

Table 8.3 Agricultural vs. industrial employment (percent of workforce)

	1901		1977	
	Agriculture	Industry	Agriculture	Industry
Italy	66	19	19	34
Emilia-Romagna	65	20	n.a.	39
Calabria	63	26	n.a.	25

Source: Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (B)," case no. 702-097, Boston: Harvard Business School 2002. © 2002 by the President and Fellows of Harvard College. Reprinted by permission. Adapted from Robert D. Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton: Princeton University Press, 1993), 153, 154, 156. Previously published in Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (B)," case no. 702-097, Boston: Harvard Business School 2002. Copyright © 2002 by the President and Fellows of Harvard College. Reprinted by permission.

Exploitative Power Relationships

Other analysts focus less on societal norms and more on underlying power relationships. Political scientist Sidney Tarrow, for example, links the South's contemporary difficulties to exploitative power relationships that could be traced to its colonial past. He notes:

> [E]very regime that governed southern Italy from the Norman establishment of a centralized monarchy in the twelfth century to the unified government which took over there in 1861 was foreign and governed with a logic of colonial exploitation. Nor did southern Italy's semi-colonial status suddenly disappear with unification. The region was joined to the North by a process of royal conquest, its fragile commercial sector brutally merged with the North's more flourishing economy, a uniform tax system and customs union imposed on its vulnerable industries, and brigandage rooted out by a full-scale military campaign. Politically, the South's communes and provinces were governed by northern administrators who regarded the region as a *terra dimissione*, and its economy was penetrated by carpetbaggers in search of new markets and raw materials ... Like the merger of West and East Germany 130 years later, a stronger, richer, more legitimate regime conquered a weaker, poorer, more marginal one, inducting its residents into political life through the tools of patronage, paternalism, and the power of money—and rubbing it in by sending in commissions of experts to shake their heads over their backwardness.[28]

Political scientists such as Tarrow use Putnam's notion of clientelism to describe the history of southern politicians and the citizenry, but use a different notion of causality. For these political scientists, clientelism was a pattern of behavior whereby citizens, instead of forming horizontal alliances and associations with others who had similar interests, demands, and levels of power, formed vertical, hierarchical, personal relationships with people who had more power in order to gain

[28]Sidney Tarrow, as cited in Jane Schneider, "Introduction: Neo-orientalism in Italy (1848-1995)," in *Italy's "Southern Question": Orientalism in One Country*, ed. Jane Schneider (New York: Oxford International Publishers, 1998), 13. A similar argument had been made earlier in Edward Banfield, *The Moral Basis of a Backward Society* (Glencoe, IL: The Free Press, 1958).

Table 8.4 Types of clientelism

Strength of Opposition	Number/cohesion of patrons	
	Few/cohesive	Many/divided
Strong	*Virtuous clientelism* (Abruzzo) Collective goods Growing legitimacy Sustained development	*Challenged clientelism* (Campania) Mixed goods Fluctuating legitimacy Intermittent development
Weak	*Vicious clientelism* (Sicily) No output No legitimacy Economic involution	*Ineffective clientelism* (Puglia) Individual goods Fading legitimacy Economic stagnation

Source: Adapted from Simona Piattoni, "'Virtuous Clientelism': The Southern Question Resolved?" in *Italy's "Southern Question": Orientalism in One Country*, ed. Jane Schneider (New York: Oxford International Publishers Ltd., 1998), 236

material advantages. The main goal of the patrons, (i.e., the local politicians), was to preserve and perhaps even enhance their power by increasing the citizenry's dependence on them. Thus, the force maintaining the behavioral pattern of clientelism has been, in their view, not so much culture as political power. Since markets would weaken the politicians' role as mediators between citizens and the state, patrons in the Mezzogiorno have sought to avoid economic integration and modernization in order to maintain their power.[29]

Other thinkers have questioned this conclusion, drawing attention to cases of patrons encouraging economic development as a means of shoring up their electoral support. Historian Simona Piattoni, for example, examines various incentives and external shocks that might influence the dynamics of the patron–client relationships. She finds that throughout the history of the Mezzogiorno, there were various types of clientelism based in part on the number and cohesiveness of patrons and in part on the strength of the opposition, whether that meant competing patrons or an alternative political system (see Table 8.4). Cohesive patrons, for example, who faced weak opposition, did not need to promote development in order to stay in power. Piattoni called this "vicious clientelism" and found it in Sicily. "Virtuous clientelism," on the other hand, was also characterized by a few strong patrons. But in this case, patrons were more likely to foster development due to a powerful opposition. In the other two situations, divided patrons were often weak and ineffective and would either be overthrown or continue along with insignificant results.[30]

[29]Simona Piattoni, "'Virtuous Clientelism': The Southern Question Resolved?" in *Italy's "Southern Question": Orientalism in One Country*, ed. Jane Schneider (New York: Oxford International Publishers, 1998), 230–233.

[30]Ibid., 234–236.

Moving Beyond Culture and Clientelism: Sources of Systemic Change

While Tarrow, Piattoni, and Putnam tell us a great deal about the persistence of clientelistic social networks through time, their models are not well suited to explaining social and economic change. For Putnam, the Italian South is mired in a low-social capital, low-cooperation equilibrium. The question of whether culture or structure (i.e. clientelism) is ultimately to blame for this is, at least for him, less important than the fact of the equilibrium itself.[31] Putnam accepts that changes in institutional structure can "affect political practice" and build social capital, but he counsels that these processes work slowly, over decades rather than years.[32] As Putnam points out, this supports the notion of the "path dependence" of social systems, or the notion that "where you can get to depends on where you are coming from."[33]

Yet as Piattoni has shown, external shocks can change the dynamics of settled patron–client relationships. These shocks can originate in the economy, in the political system, or in civil society. Politically, this might take the form of determined action by a central government to reform dysfunctional institutions. Socially, it could be sparked by a popular revolt against the excesses of these institutions and the values they represent. And, as we will see below when we discuss the Mafia, the Italian state and people have, from time to time, fought hard to dismantle this system-within-a-system. While the systemic barriers to change emphasized by Putnam and others make thoroughgoing reform difficult, they do not render it impossible.

A Weak State, Private Law and Order, and the Role of the Mafia

The Mafia is the clearest, most egregious manifestation of Southern Italy's oppressive patron–client culture. In this section, I draw attention to aspects of its history, from its beginnings as an informal provider of private protection services in post-feudal Sicily, to its emergence as a major socio-economic phenomenon in the late 19th century. I examine the Mafia not only as an example of vicious clientelism, but also as a criminal enterprise that is rival to the Italian state, an alternative system of governance for Southern Italy with its own family structure, institutional rules, support networks, and value systems. As we will see, Rome's mixed record in combating the Mafia demonstrates the difficulty of breaking down exploitative, clientelistic social systems as well as the need for these efforts to be backed by sustained popular demands for change.

The Mafia's Beginnings

The Mafia was already a force in Sicily at the time of Italian unification in 1860. Although its precise origins have yet to be documented, recent scholarship attributes

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[31] Putnam, *Making Democracy Work*, 181.

[32] Ibid., 184–185.

[33] Ibid., 179.

its rise to the end of feudal land ownership in Italy at the end of the Napoleonic wars. Land ownership had been in the hands of rich aristocrats, the Church, and various communities in the form of a commons, and it had been inalienable. With the end of feudalism, these holdings were broken up, and much of the Church land was confiscated and sold.[34]

In Sicily, this process was anything but smooth. Feudalism was formally abolished in 1806 in the continental South and in 1812 in Sicily. This transformation was accompanied by strife and violent conflicts for more than a 100 years, until after the Second World War.[35] The nub of the problem was that land changed from being in a few, strong hands with clear rights to ownership, to being in many hands with insecure title. Thus, between 1812 and 1860, the number of Sicilian landowners increased from an estimated 2,000 to 20,000, and from 1860 until 1900 the number of hectares in private hands more than doubled.[36] This change created a new market for the protection of land and other private property throughout Italy. The problem was that the market demand for protection did not become a monopoly of the state. As Diego Gambetta points out:

> A variety of potential markets opened up, and protectors began offering their services to classes other than the aristocracy. . . . [This new market] was not satisfied merely through brute force. . . . there were professions involving the manipulation of private trust, such as notaries, lawyers, doctors and even priests. Gradually those who succeeded became autonomous suppliers. Autonomy was the key element missing in other parts of the Mediterranean.[37]

Early Mafiosi were often shepherds or others who worked the land, but who had the entrepreneurial vision to spot a market opportunity. Local peasants often viewed these Mafiosi as Robin Hoods protecting the weak against bandits as well as a distant and erratic state.[38] Accordingly, when Garibaldi's troops landed in Sicily in 1860, they were not greeted as liberators but as intruders. Sicilians refused to cooperate with the new regime, and the term Mafia dates from this period. A Tuscan visitor to Sicily made the following observations in 1876:

> Matters naturally reached a point where the instinct of self-preservation made everyone ensure the help of someone stronger; since no legitimate authority in fact existed, it fell to clientelism to provide the force which held society together. . . . A very unequal distribution of wealth; a total absence of the concept of equality before the law; a predominance of

[34]Diego Gambetta, *The Sicilian Mafia: The Business of Private Protection* (Cambridge: Harvard University Press, 1993), 91.

[35]Ibid., 80.

[36]Ibid., 91.

[37]Ibid., 80.

[38]The Mafia provided its own regime of justice as well as protection. Thus mafiosi came to describe themselves as "men of honor," with a formal initiation and a strict code of behavior which, among other things, forbids affairs with wives of other mafiosi or killings that were not "essential." Membership was never formally acknowledged to outsiders, and all activities were protected by a vow of silence toward all but the few with a need to know. See John Andrews, "Midday Shadows," *The Economist*, June 26, 1993.

> individual power; the exclusively personal character of all social relations; all this [was] accompanied (as was inevitable) by the bitterest of hatreds, by a passion for revenge, by the idea that whoever did not provide justice for himself lacked honor.[39]

Mafia families emerged to supply private protection services in some areas and not in others. Indeed, the Sicilian Mafia emerged with a decided concentration toward the western side of the island and in the city of Palermo in particular, a pattern that was almost unchanged a century later.[40] Other Mafia-like organizations took root around Naples and in Calabria, though not all provinces of the Mezzogiorno were affected, and those that were affected were affected unequally.

The Suppression and Rehabilitation of the Mafia

The relationship between the Mafia and the Italian state is a complex one. Official efforts to break the Mafia's influence have been intermittent and have had mixed success. Often, the Mafia has been tolerated. Sometimes—when their interests have coincided—the State and the Mafia have worked together. I will not attempt a full history of State-Mafia relations here. My intention is to draw attention to select episodes in this still-unfolding story and to link this to my wider discussion of the Italian South.

As mentioned above, the Mafia was well-established in Sicily at the time of Italian unification in 1860. When violence in Sicily caused a cabinet crisis in Rome in the early 1870s, a deal was reached.[41] The Mafia would refrain from being so visible, and the central government would accept its presence as a force for order and stability; this pattern would persist for the next 50 years.

The pattern of tacit toleration of the Mafia was temporarily broken by Mussolini, who conducted a determined campaign against the Mafia. Yet the extra-judicial excesses of this campaign, which was headed by a pro-consul with extraordinary powers, actually resulted in some revival of Southern support for the Mafia. The Mafia drew further strength from the American invasion of Italy in 1943, securing supplies from Italian-Americans in the US Army. This was buttressed by an influx of deported Mafia figures from the US after the War.

The Mafia's fortunes during the Cold War period were shaped by a covert deal with the Christian Democrats, Italy's main non-communist political force. Under this arrangement, the Christian Democrats offered political tolerance of and protection for the Mafia in return for the support of the Mafia in mobilizing votes in the South. As its part of the bargain, the Mafia would serve as the armed force of the Christian Democrats in dealing with the Communists, including assassinations as necessary.[42]

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[39] Cited in Putnam, *Making Democracy Work*, 146.

[40] Gambetta, *The Sicilian Mafia*, 81–82.

[41] Stille, *Excellent Cadavers*, 15–16.

[42] Ibid., 19.

The prominence of the Mafia in Italian life did not go unchallenged. Anti-Mafia activists faced two difficulties in their efforts to mobilize public support: first, the dependence of so many on Mafia favors, giving them an effective stake in the organization and, second, the backing the Mafia received from civil institutions such as the Church, schools and the media. The press frequently labeled anti-Mafia activists as "careerists" who were hungry for power. A Palermo daily, *Giornale di Sicilia*, was particularly intimidating. By 1987, it had dismissed several anti-Mafia reporters and listed the names and addresses of the founding members of one anti-Mafia group. The situation was similar to that in the 1960s, when Palermo's Archbishop Cardinal Ruffini claimed that "the Mafia exists only in the minds of those who wish Sicily ill."[43]

"Clean Hands" and the "Retaking" of Sicily

It was only the collapse of the Soviet Union in 1990 that allowed Italy to begin a program of far-reaching reform. Two events in 1992 provided an impetus for change. First, a chance investigation in Milan grew rapidly into a major scandal involving wholesale corruption within the major parties and much of the business leadership. Called the "clean hands" investigation, it led to the downfall of two prime ministers and the indictment of some three hundred members of the Italian elite. The second event came as this investigation was at its peak: Two Sicilian magistrates, Paolo Borsellino and Giovanni Falcone, who were making remarkable progress in their decade-long investigation of the Sicilian Mafia, were assassinated along with their bodyguards.[44]

These two events drew a strong response from the government, which was at the time under the leadership of Giovanni Spadolini, a prime minister from the small and relatively clean Republican party.[45] New laws were passed to criminalize membership in the Mafia, increase the protection of witnesses, and increase the investigative powers of the magistrates. Some seven thousand troops were sent to Sicily to protect the citizenry. And more than fifty villages and towns replaced their governments because they were deemed to have been infiltrated by the Mafia.[46] Importantly, these steps were enthusiastically backed by the public, South as well as North. In Sicily, tens of thousands of people took to the streets to protest the assassinations of Falcone and Borsellino and to demand reform. As Alexander Stille has pointed out:

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[43]Jane Schneider and Peter Schneider, "The Anti-Mafia Movement in Palermo," in *Between History and Histories*, ed. Gerald Sider and Gavin Smith (Toronto: University of Toronto Press, 1997), 251–252.

[44]Bruce R. Scott and Jamie Matthews, "'One Country, Two Systems'?: Italy and the Mezzogiorno (B)," Harvard Business School Case No. 702-097, 8.

[45]It is worth noting that the Government was headed by the leader of the Republican Party, which had not been implicated in the scandals being investigated under the "clean hands" banner.

[46]Sondra Z. Koff and Stephen P. Koff, *Italy: From the First to the Second Republic* (London: Routledge, 2000), 99.

> Falcone and Borsellino had a lot to do with this social change. Past crusaders against the mafia, from Mussolini's "Iron Prefect" Cesare Mori to General Dalla Chiesa were, like Garibaldi's conquering troops, northern Italians on a mission to civilize the island and link it to the rest of Italy. Falcone and Borsellino offered a new image of the state: serious, uncompromisingly honest and profoundly Sicilian. By bringing the mafia to trial, they proved that the mafia is not invincible. And they did so through the scrupulous use of the legal code. "The most revolutionary thing you could do in Sicily," Falcone once said, "is simply to apply the law and punish the guilty."[47]

This change in public attitude led to the election of Leoluca Orlando, a reform-minded politician, as mayor of Palermo; he made a determined effort to retake the schools as well as establishing citizen efforts to clean up graffiti that had defaced public buildings and monuments in the city.[48] Even the Catholic Church abandoned its indifference to, or covert acceptance of, the Mafia.[49] The "clean hands" investigation resulted in the resignations of hundreds of business as well as political leaders, the permanent exile of the leader of the Socialist party, a change of name and agenda for the Communist Party, the collapse of the Christian Democratic Party, and a change from proportional representation to "first past the post" election of most deputies in Parliament. Italians soon dubbed these changes the shift from the "first republic" to the "second."[50]

Notwithstanding these changes, it is not at all clear that lasting gains have been made against the Mafia. Over the course of the 1990s, there were some positive trends. The city of Palermo went from having two hundred murders per year in the 1980s and early 1990s, to between six and fourteen per year from 1994 to 1999.[51] And Southern Italy experienced a resurgence of small firms, tourism, and exports, developments that were expected to help narrow its income gap with the North of the country. Since small firms were much more susceptible to Mafia-based extortion than large firms, their economic health was often taken to be a sign of diminished Mafia influence.

More recent signs have been less encouraging. Legal reforms introduced by Silvio Berlusconi, for example, have made it harder to prosecute white-collar crime, a major area of Mafia activity. And in Sicily, there appears to be evidence of a Mafia

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[47] Stille, *Excellent Cadavers*, 411.

[48] Enzo Lo Dato, "Palermo's Cultural Revolution and the Renewal Project of the City Administration," *Trends in Organized Crime* 5, no. 3, "From a Culture of Lawfulness to an Economy of Legality," symposium on the role of civil society in countering organized crime: Global implications of the Palermo, Sicily renaissance, Palermo, Sicily, December 2000. (March 2000): 10–34.

[49] Salvatore Di Cristina, "The Church's Moral Condemnation of the Mafia and the Clergy's Role in the Parish," *Trends in Organized Crime* 5, no. 3, "From a Culture of Lawfulness to an Economy of Legality," symposium on the role of civil society in countering organized crime: Global implications of the Palermo, Sicily renaissance, Palermo, Sicily, December 2000. (March 2000): 39–45.

[50] See Scott and Matthews, "One Country, Two Systems (B)," 9.

[51] See Lo Dato, "Palermo's Cultural Revolution and the Renewal Project of the City Administration."

resurgence; according to a leading anti-Mafia judge, this is due to its reorganization under Bernardo Provenzano on the one hand and the fading of public outrage on the other.[52] In 2003, *The Economist* highlighted the Sicilian Mafia's widespread harassment of administrators running confiscated, formerly Mafia-owned businesses. In the same report, a Palermo court official claimed that Sicily's economy is still under Mafia control.[53]

As a fully-fledged institutional structure, the Mafia has continued to resist the Italian state's periodic attempts to suppress it, drawing on its networks of support within the Church and other prominent professions and relying on public acceptance of (or at least cynicism toward) the values it represents. In those instances where the government has indeed cracked down, success has often depended on popular support and broad-based calls for change. The state's inability to sustain such support over time helps explain why the Mafia, to this day, remains influential in the Mezzogiorno.

Conclusions and Implications of Italy's Two Systems

One of the most basic responsibilities of a modern state is protecting its citizens from physical harm while also protecting their property. In order to do this, the state must have a monopoly of the use of coercive force, both to apprehend criminals and to settle disputes. In Italy, the writ of the state has been and remains weak overall, and significantly weaker south of Rome. In contrast, the power of the Mafia, while challenged at times, has remained strong and even grown. Political deals dating back more than a century accorded the Mafia a role in the protection of property rights in various areas south of Rome, and much of this power was reestablished after World War II. Mafiosi as well as political patrons thus did and still do influence the distribution of employment, pensions, and contracts on the one hand and the "enforcement" of contracts on the other. The Italian state remains too weak to have a monopoly of violence within its domain.

The truncated role of the Italian state seems fundamental to Italy's regional differences, both institutional and cultural. It was Cicero who observed 2,000 years ago that "[N]othing is to be maintained in a state with such care as the civil law. In truth if this is taken away there is no possibility of anyone feeling certain what is his own property or what belongs to another."[54] Italy's cultural norms seem to constitute a clear but relatively "soft" set of differences between the North and South, while differences in law enforcement seem to constitute a much "harder" if perhaps

[52] Kevin Cullen, "In Sicily, Don Leads Comeback of the Mafia," *The Boston Globe*, May 29, 2001.

[53] "Mafia Businesses," *The Economist*, October 18, 2003, 63.

[54] Cicero, as quoted by David Moss, "The Foundations of American Risk Management Policy," in *When All Else Fails: Government as the Ultimate Risk Manager* (Cambridge: Harvard University Press, 2002).

less visible set. If by habit or culture we obey traffic signals and other community norms, ultimately this obedience depends upon some means of enforcement, and usually upon hard legal enforcement by the police, backed, if necessary, by the courts. In this way, fundamental differences in law enforcement underlie the more apparent, surface differences between the North and South, i.e., those of culture and economy.

Thanks to its incomplete or truncated state, Italy has been one country with two systems in a political and legal as well as cultural sense. While it had one legal system in terms of form, it had two legal systems in terms of enforcement and thus in reality. The vertical relationships found in the South did not survive just through the inertia of established behavioral patterns; rather, they were perpetuated by the dispensing of favors to those who obeyed the extra-legal norms and, if necessary, by violent oppression of those who failed to obey. In future years, the test of whether Rome has in fact "retaken Sicily" and reincorporated it in a single institutional system will be whether political patronage and law enforcement norms as well as cultural norms in the South converge toward those in the North. Certainly, the North does not boast a perfect political system; for instance, the re-election of Silvio Berlusconi as Prime Minister in 2001, while he was under multiple indictments for corruption, raises questions about Italy's legal system in the North. It may be a generation before we begin to have answers on Italy's progress toward legal and political reform, North or South.

The foregoing analysis and conclusions suggest several tentative implications for other countries. First, and of fundamental importance, the persistently poor economic record of the Mezzogiorno (leaving Abruzzo to one side) implies that economic markets, even when supplemented by decades of active public support through a variety of schemes, are not enough to overcome deep-rooted social and institutional obstacles to development. As Putnam and others point out, these obstacles (whether reflected in social capital or unequal power relationships) tend to reinforce each other and to resist pressures for change. They are not market imperfections in any usual sense of the term, but are themselves fundamental elements of distorted market frameworks, and deliberately contrived and maintained distortions at that. Equilibrium conditions in these economic markets in no way indicate that they approach optimality for Italian society.

Second, and perhaps of even greater importance, one should recognize that the crucial market failures in Italy are not in its economic markets but instead in its political markets and the related institutions of its political system. Too many parties result in ever-changing alliances and a continuing pre-electoral situation. It is difficult for any Italian government to have even medium-term plans, let alone aspirations for the longer term. The admitted failures in Italian economic markets, such as the wage parity between Southern and Northern labor markets, when there is not parity in their respective levels of productivity, are very important but they pale in comparison with the continuing failures in its political markets.

Third, political markets, like their economic counterparts, cannot regulate or heal themselves. It takes sustained political pressure to bring about such reforms, and this pressure must come through the political processes. When massive corruption was found in the North and two Sicilian magistrates were assassinated while uncovering Mafia misdeeds, both Northern and Southern Italians demanded change. And for a time, it appeared as though fundamental reform, political as well as administrative, might result, as indicated by the figurative shift from the first republic to the second. In his gripping account of the history of the Mafia, *Excellent Cadavers*, Alexander Stille made the fundamental point as follows:

> The experience of the last forty years what should have been obvious from the start: a governing class that lives enmeshed in illegality is in no position to conduct a serious, sustained program against organized crime . . . The political support for this most recent crackdown was determined, in part, by the anomalous atmosphere, created by the massive government bribery investigation, Operation Clean Hands.[55]

Italy needs a cultural revolution to achieve real reform. At this writing, it appears that cultural upheaval and demands for reform slowed too soon to force the needed political transformation that would in turn bring more determined law enforcement to the Mezzogiorno. While I have taken the North as the more model society in this discussion, the North has itself more tolerance for corruption than one would normally expect, reducing the prospects for thorough-going reform as attempts are made to drastically curtail clientelism in the South.

Fourth, the case of southern Italy demonstrates that while markets alone cannot achieve reform, economics does matter. Poorly conceived economic policies played an important role in the region's disappointing performance. Specifically, an artificially high wage structure, subsidized state-owned enterprises, excess government employment, and generous transfer payments all contributed to a culture of dependency, limiting the incentives for those in the Mezzogiorno to take advantage of Northern growth and dynamism. Implicitly, Rome's economic strategy exacerbated the region's worst clientelistic traditions by fostering dependence.

In theory, the Italian state had the power to take charge in Sicily, to decapitate local governments, and to pursue the Mafiosi relentlessly. It used this power briefly between 1992 and 1994, thanks to a government that was largely technocratic. This period of reform ended with the election of Silvio Berlusconi in 1994; from this time onward, Rome set out to rein in the pursuit of criminals and also to make it much easier for those in jail or under indictment to secure acquittals. Italy's era of attempting to clear up its problems in the Mezzogiorno was thus brief and inconclusive.[56]

A fifth lesson from Italy is the power of history. In the absence of sustained societal demand for far-reaching change, vastly unequal power relationships established in colonial times can carry forward indefinitely. If these unequal power relationships can exist for over a century in a developed country that is now part of the European Union, consider how much easier it must be for a similar heritage to survive and inhibit development in a newer and less developed country. Moreover, if the people of the Mezzogiorno have not able to take anything like full advantage of the enhanced opportunities provided by the unified Italian market, let alone the

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55 Stille, *Excellent Cadavers*, 407–408.

56 Scott and Matthews, "One Country, Two Systems (B)," 9.

European market, consider how disempowered the people in developing countries must be, lacking any such opportunities of which to take advantage.

As a final and perhaps most important implication, what can we conclude about the prospects for reform based upon international assistance, or for assistance with pressure for reform? The Mezzogiorno provides a sobering lesson. The EU has given the Mezzogiorno preferred status for assistance for almost half a century, but has very little to show for it. Italy enjoys a seat at the Council of Ministers in Brussels and thus the right to veto any reforms that it opposes. For some senior officials in the European official assistance community, the Mezzogiorno is like a sinkhole where almost endless amounts of resources can be wasted because the EU officials are impotent to impose conditionality. We will see a somewhat parallel situation between the US and the IMF referenced in the Epilogue. Somewhat in contrast Ireland and Portugal have flourished, thanks in part to external assistance from EU institutions. Barring an extraordinary crisis, reforms needs to be driven from within the country, and Italian elites have not shown the combination of courage or determination to weed out corruption in Rome let alone to its south.

Democracy is a remarkable form of governance, but absent an effective state there cannot be liberal democracy in any authentic sense. Intimidation and corruption will persist and taint the lives of the people. Large firms can protect themselves, but the masses of relatively smaller firms and people will remain vulnerable. For instance, Catania, a Sicilian seaport in the heart of Mafia country, has been able to attract large-scale semiconductor manufactures because the firms can work out their own protection schemes; small entrepreneurs let alone farmers cannot achieve such protection without effective support of the state. The result of this absence of effective state power to protect the people of Southern Italy is a key component in the great socioeconomic gulf between the two regions. While the material standard of living in Sicily and elsewhere in the Mezzogiorno has improved greatly since the end of World War II, the citizenry does not enjoy the civil liberties of the North.

Chapter 9
The United States as "One Country, Two Systems"

Co-authored by Jamie Matthews

From its inception as an independent country, the United States hosted two social systems, one that officially recognized slavery and one that did not. Delegates to the Constitutional Convention were unable to agree on the elimination of slavery, ultimately allowing it to persist by state discretion and thereby allowing its extension throughout the nation. Seventy years later, at the time of the Civil War, slavery was exclusive to the south. Two distinct social, political, and economic systems characterized a divided house: a more urbanized and rapidly industrializing north, based largely upon free labor, and a mostly rural, agricultural south, based in considerable measure on slavery.

Though a variety of other reasons can be cited, the American Civil War was not fought over slavery itself but rather over the spread of slavery within the nation; the peculiar institution's complete abolition, and thus the unification of the country's systems, was not a necessary end. Implicitly, this indicated an acceptance of the belief that the Union could exist as one country with two social systems. With the Emancipation Proclamation in 1863, the official war aims changed to include the abolition of slavery in the Confederate states and eventually in all areas within the Union. Paradoxically, even with 4 years of all-out war and 12 years of military occupation, the United States still arrived at a de facto settlement by which it would operate as one country with two social systems, one almost officially segregated and the other not. Unification, in belief *and* practice, did not come until about a century later, with the Civil Rights Acts of the 1960s and their enforcement by the federal government.

In this case study, I ask why the Union victory and the abolition of slavery did not bring about a true fusion of the two social systems that had existed before the Civil War. One of the surest indicators that the two systems remained quite distinct was that average incomes in the south remained at about 46% of those in the north until the 1940s, except briefly in the 1920s when they were even lower, as shown below in Table 9.2. Why would southern incomes fall relative to those in the north even before the Civil War when the two regions were part of a single country with free trade and free movement of capital, if not free movement of labor within the

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_9,

south or from the south to the north? And, still more urgently, why would southern incomes fail to converge with those of the north prior to 1940, or 75 years after the end of the Civil War?

In order to answer either of these questions, we need to understand the underpinnings of the south’s pre-Civil War economic system and how these institutional foundations could contribute to its economic lag and/or decline relative to the north. Then we need to consider why these underpinnings and their effects did not improve even following the Civil War; specifically, we need to understand why the Civil War and the 12 years of military occupation known as Reconstruction failed to set the south on a path to achieving economic or indeed institutional convergence with the north. Finally, we need to consider how various reforms beginning in the 1930s, together with a labor shortage in the 1940s, finally brought economic, political, and social changes that together allowed southern incomes to start converging with northern incomes. In reality southern incomes converged somewhat during World War II, thanks to certain unusual wartime conditions including an absence of immigration from abroad, which helped induce a large exodus of low-skilled labor to better paying jobs in the north, while institutional convergence (meaning an end to segregation) was delayed until the 1960s, at which point one could begin to speak of the United States as one country with one social system.

In the following analysis, it is not my intent to add to the existing body of scholarship on the history of the south.[1] Rather, I intend to focus on the institutional differences that persisted in spite of massive armed intervention in the 1860s and 1870s and a variety of other interventions in the 1930s and 1940s. Institutional convergence, i.e., the end of legalized segregation and discrimination, was delayed until political reforms in the 1960s backed federal intervention, including a renewed use of force. I review the existing literature in order to draw out why this convergence was so long deferred and why it eventually succeeded in eliminating formal segregation, though not necessarily racism.

Income Divergence in the Antebellum Economy?

The US economy before the Civil War was characterized by a divergence of incomes between the two regions, with the south falling behind the north. In 1774, the states that would eventually secede had incomes about equal to those in New England, and the wealth (including slaves) was disproportionately located in the south (Table 9.1).

By 1840, when the last pre-Civil War census of manufactures was taken, southern incomes had fallen behind those in the north, and the southern share of the population had declined to slightly more than one-third, reflecting a ban on the importation of slaves as well as the reluctance of white immigrants to compete with slave labor. Incomes in the northeast (New England plus the Middle Atlantic States) were almost

[1] This section draws heavily on Gavin Wright’s excellent economic history of the South, *Old South, New South: Revolutions in the Southern Economy since the Civil War* (New York: Basic Books, 1986).

Table 9.1 Relative per capita incomes as a percentage of the average

	1774 (%)	1840 (%)
New England	96.6	117.3
Middle Atlantic	106.9	106.8
South	96.6	75.8

Notes: New England = Maine, Massachusetts, New Hampshire, Connecticut, and Rhode Island; South = Maryland, Virginia, North Carolina, South Carolina, and Georgia; Middle Atlantic = New York, New Jersey, Pennsylvania, and Delaware.
In calculating the average, each region was weighted by 1.
Sources: 1774: Alice Hanson Jones, *Wealth of a Nation to Be: The American Colonies on the Eve of Revolution*, New York: Columbia University Press, 1980, 63. 1840: Richard A. Easterlin, "Interregional Differences in Per Capita Income, Population, and Total Income, 1840–1950," in *Trends in the American Economy in the Nineteenth Century,* Studies in Income and Wealth 24 (NBER Books, 1960)

double those in the original (now south Atlantic) states. The newly added north Central states, including Kansas, Nebraska, and the Dakotas, had approximately the same incomes as the south Central states (Alabama, Mississippi, Kentucky, and Tennessee) while the newly added trans-Mississippi states (Arkansas, Louisiana, Oklahoma, and Texas) had the highest incomes of all.

By 1860, southern incomes east of the Mississippi, where 85% of its population lived, had slipped further relative to the north, but the southern average had gained slightly as a result of rapid population growth in the trans-Mississippi states, where incomes were almost twice those East of the Mississippi. The point then is not that the south was poor; in 1860 the southern states' income level ranked second only to that of England in Europe. Rather, it is that northern incomes were 40% higher on average, and gaining, with corresponding gains in relative population (Table 9.2).

With its advantage in terms of income and a relatively egalitarian social system, the north was attracting more immigrants than the south and thereby adding to its relative power. Indeed, southern recognition of this was a key reason for the south's

Table 9.2 Per capita incomes in the US northeast and south (current dollars)

	1880	1900	1930	1940	1950	1960	1970	1980	1990	2000
Northeast	120	141	865	782	1,721	2,588	4,586	10,915	22,660	34,467
South	56	67	333	361	1,106	1,737	3,403	9,005	17,359	26,753
South as % of northeast	46.7	47.5	38.5	46.2	64.3	67.1	74.2	82.5	76.6	77.6

Note: Northeast includes Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont. South includes Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, West Virginia.
Source: 1880 and 1900: Adapted from data in Easterlin, "Interregional Differences in Per Capita Income, Population and Total Income, 1840–1950," in *Trends in the American Economy*. 1929–2001: United States Bureau of Economic Analysis data

secession and the resulting Civil War. A related reason was the desire of the southern elite to retain its positions of power and privilege that were intimately tied up to its slave-based system.

Why had the economy of the old south diverged so sharply from that in the north when both were, at least nominally, part of the "same" economic system, governed by the same Constitution, and presumably subject to the same laws and court decisions? Almost from their inception, the southern colonies followed a different path from their northern counterparts, with the former specializing in large-scale plantation agriculture and the latter in small farms with diversified crops. Why did this occur? Economists Stanley Engerman and Kenneth Sokoloff have suggested that factor endowments (broadly conceived as soil, weather conditions, and lack of indigenous people to enslave) were pivotal in explaining the widespread adoption of the institution of slavery largely, but by no means entirely, in the south.[2] By using slave labor, the southerners were able to build comparative advantage and export to world markets, as well as to the north. At the same time, however, the slave-based system meant that up to 50% of the population in some of the slave states was denied the freedom to acquire skills through education, the right to own property, and the opportunities that went with personal mobility. The south was developing its natural advantages but stunting as well as exploiting the capabilities of a large fraction of its population.

Slavery affected the early development of the south in more subtle ways as well. With most of their wealth tied up in slaves (two-thirds on average), slave-owners naturally strove to maximize the value of this asset. Given the mobility of forced labor, owners could afford to be footloose, regularly moving their slaves from place to place to access the most fertile land.[3] In contrast to their land-owning counterparts in the north, slaveholders had little incentive to invest in regional infrastructure, schools, or roads or to encourage the growth of towns, all activities that were associated with rising land prices, but which had no obvious impact on slave values. Thus, the south remained much more rural and institutionally underdeveloped than the north (Table 9.3). For similar reasons, southern slaveholders did not diversify their economic activities, for example, by investing in manufacturing. In 1840, the south's per capita investment in manufacturing was less than one-third of the north's, a trend attributable to the south's lack of urbanization, lack of infrastructure, unequal distribution of incomes, smaller home markets, and poor access to resources (like coal and iron ore).[4] Even the slave-trade industry received little support; from the early 19th century, slave-owners opposed further inflows of slaves, fearing they would drive the slave market down. This isolationist tendency was reinforced by internal

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[2]Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*.

[3]Wright, *Old South, New South*, 17–18.

[4]Ibid., 28. Wright points out that 19th century manufacturing was highly resource intensive, meaning that many industries needed to be located close to key resources like coal and iron ore. He notes that slave-owners, because of their focus on "human capital" rather than land values, did not aggressively search for mineral wealth.

Table 9.3 North–south differences, c. 1840–1860

	Colonial north	Colonial south	Expanded north	Expanded south
Urbanization (1840)	13.7%	4.9%	10.0%	4.7%
Miles of railroads (1852)				
Per square mile	0.037	0.011	0.020*	0.006[a]
Per 1,000 people	0.701	0.494	0.617*	0.322[a]
Capital invested in manufacturing per capita (1840)	$27.34	$7.41	$21.93	$7.16

Colonial north = ME, NH, VT, MA, RI, CT, NY, NJ, PN, DE; Expanded north = Colonial + OH, IN, IL, MI, WI, IA.
Colonial south = MD, VA, NC, SC, GA; Expanded south = Colonial + Alabama, Mississippi, Tenn, Kentucky, Flor, Arkansas, Louisiana.
[a]Data not available for Iowa, Florida, and Arkansas. These states probably had no railroad mileage.
Sources: Easterlin, "Interregional Differences in Per Capita Income, Population and Total Income, 1840–1950," in *Trends in the American Economy*. Railroad mileage: *Seventh Census of the United States* (United States Census Bureau, 1850). Manufacturing investment: *Sixth Census of the United States* (United States Census Bureau, 1840), vol. 3

migration, which tended to be east–west rather than south–north, a pattern that minimized the need for settlers to make difficult adjustments, either in farming (i.e., soil, crops, and climate) or in social terms.[5]

The logic of the slave-owning economy, therefore, is an important factor in explaining the antebellum economic profile of the south, which was overwhelmingly agricultural and rural, with few large towns, a poor transportation network, and slower growth. If this were the entire story, we might expect the abolition of slavery to unlock the south's pent-up economic potential, allowing it to converge toward northern living standards. The fact that this did not start to happen for another 80 years requires us to consider a deeper set of phenomena that shaped the region's development prospects long after the abolition of slavery.

From Factor Endowments to Institutional and Political Sources of Inequality

Engerman and Sokoloff argue that differences in "long-run paths of development" across the Americas were associated with contrasts in the "degree of inequality in wealth, human capital and political power."[6] According to this view, relatively unequal societies were more likely to develop economic and political institutions

[5]Ibid., 9.

[6]Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 1.

that favored existing elites, denying opportunities to the majority of their populations. These unequal institutional frameworks were also associated with the under-provision of such public goods and services as law enforcement, education, and physical infrastructure, as well as with poorer long-term performance. In their analysis, rich factor endowments seem to be the fundamental cause behind such inequality, whether in north or south America and thus to explain most of the north–south differences in the Western Hemisphere. Their logic is that rich factor endowments were an attractive target for capture and exploitation, typically by some form of forced labor, which could be achieved either by oppressing a weak and disorganized native population or by importing slaves. Then, once established, a rich elite had strong incentives to entrench and extend the distorted institutions that benefited the few at the expense of the many.

As luck would have it, the colonies north of the Chesapeake Bay did not have such “rich factor endowments,” lacking both a climate suitable for growing plantation crops and precious metal mines. As a result, there were few economies of scale in northern farming. Additionally, these northern colonies lacked the human resources to set up large plantations; there were relatively few Amerindians to exploit, most of whom would perish through disease, and with few economies to reap, very few farmers were likely to invest in slaves. Instead, many immigrants were attracted to come as indentured labor for a fixed period of time, after which they were free. With the existence of cheap or even free land on the frontier, most free men preferred to own their land and farm for themselves rather than for someone else. These circumstances of modest factor endowments, in terms of the productivity of land and/or a small indigenous population to press into forced labor, created a context in which there were very few, if any, advantages to concentrated land ownership.

This pattern of modest factor endowments in the north may have been necessary in order to avoid a system based upon forced labor and thus encourage a situation where the levels of financial wealth were relatively equal, but by itself it was not sufficient. Argentina, Uruguay, and the southern part of Brazil had broadly similar factor endowments, but still ended up with vastly unequal land holdings and wealth, as well as institutional patterns associated with rich endowments, a situation I explored in Chap. 6. Two examples reinforce this broader argument. Georgia initially had a constitution that forbade slavery, but it was soon changed in order to take advantage of its geographic circumstances.[7] On the other hand, William Penn was given a vast grant of land in what would become Pennsylvania. With few economies of scale, his land grant was soon broken up into many small holdings. A crucial difference between Pennsylvania and Argentina was that would-be farmers in the former could migrate to the frontier and avail themselves of almost free land, while in Argentina the state kept control of the land and doled it out to important persons as a matter of policy. Immigrants to the north had an opportunity that those

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[7] Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 6.

going to Argentina or Brazil could not match. The existence of nearby economic opportunities thus had a decisive impact on the scale of land holdings and the methods of farming in Pennsylvania, while the political "flexibility" of white immigrants in Georgia allowed them to overturn their constitution so that they could practice slavery.

Once two patterns of land holdings were established in the south and in the north, the United States came to resemble one country with two systems, one that made wide use of slave labor and one that did not. The south had patron–client relationships much like those in Latin America or the Mezzogiorno, except that in the south they were based upon race as well as class. Moreover, in the south, these vertical relationships were legally binding, with few limits on how brutally the master could treat his slaves.[8]

Engerman and Sokoloff have proposed a theory with considerable explanatory power to help us understand why the south's economic performance was initially strong, i.e., until circa 1750, and why it would subsequently lag behind the north's long after slavery was abolished. They posit a two-way relationship between factor endowments and institutions—that is, unequal factor endowments shape and are in turn reinforced by wider social and political institutions.[9] These unequal or exploitative institutions were shaped by and for the benefit of a small elite, which was able to entrench and extend its institutions so that it dominated southern life, even in areas not particularly conducive to plantation agriculture. While slavery's most egregious manifestations were removed by the Civil War, profound inequality remained in its institutions, both political and economic, and they remained a handicap to its development for decades to come.

Free Markets Without Convergence; or Convergence Postponed

The United States suffered 4 years of Civil War from 1861 to 1865, with a total of 600,000 deaths and vast destruction of southern property before the north could subdue the south and re-establish the Union. This "hostile takeover" gave the north the power to force institutional changes on the south, but did not guarantee that it would effectively do so. Indeed, one might well expect that the result would have been institutional convergence toward a single system, as implied by the change in the use of the term "United States": in the antebellum period, it was the custom to say that the United States "are" a democracy; after the war it became the norm to say that the United States "is" a democracy. Given this nominal convergence to one

[8]The southern economy was far from uniform, with the richest factor endowments concentrated in areas such as the Mississippi delta, and it was in such areas with rich soils that slavery was most preponderant. In 1860 slaves varied from about 49% of the population in the first five states to secede to 29% in the last five and less than 14% in the four border-states that did not secede.

[9]Engerman and Sokoloff, *Factor Endowments, Inequality, and Paths of Development Among New World Economies*, 17.

system, how are we to explain the failure of real convergence, in terms of institutions as well as incomes, from 1880 until 1940, as shown in Table 9.2?

The Civil War was initially fought to end the secession and to stop the spread of slavery, not to abolish it in the South. President Abraham Lincoln added an important additional objective with his Emancipation Proclamation, freeing all of the slaves in Confederate territory in the event that the North won; however, the Proclamation did not free the slaves in the border-states, let alone guarantee black voting rights or equal protection in any state. When Confederate General Robert E. Lee surrendered to Union General Ulysses S. Grant in April 1865, the key question facing the victors was on what terms the south would be readmitted to the Union. How much emphasis would the north place upon institutional reform of the south, commonly known as Reconstruction, and how much on reconciliation after such a costly and divisive war? Indeed who was to be included in the "reconciliation,"—the whole population or just the whites?

As historian David Blight notes, "The great challenge of Reconstruction was to determine how a blood feud could be reconciled at the same time a new nation emerged out of war and social revolution."[10] Was reconciliation to be between the whites, north and south, or between the whole population, north and south? Reconstruction was premised on the notion of a transformation of the south that would not only ensure emancipation, but also abolish the patron–client relationships of the plantation system where labor was tied to the land. Could this be accomplished without full rights for northern blacks? How strong was the northern political constituency for Reconstruction, and how was it to be carried out? While Abraham Lincoln might have been able to guide a simultaneous process of reconciliation and Reconstruction, he was assassinated within days of Lee's surrender. The fate of Reconstruction was then further complicated by the swearing in of Andrew Johnson, a southerner and unreconstructed white supremacist, as Lincoln's successor.[11]

The Thirteenth Amendment, abolishing slavery, was ratified in 1865, but it remained to be decided what rights blacks should have and by what processes these rights should be entrenched. Johnson's plans called for rapid readmission of the former Confederate states, based on a broad amnesty for participants and pardons for those who would take a loyalty oath to the Union. Former high officials and those with more than $20,000 in property had to apply directly to the President for their pardon. But this plan made no provision for black civil or political rights.[12] Even worse, "He [Johnson] openly encouraged the south to draft its notorious Black Codes, laws enacted across the south by the fall of 1865 that denied the freedmen political liberty and restricted their economic options and physical mobility."[13]

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[10] David W. Blight, *Race and Reunion: The Civil War in American Memory* (Cambridge: Harvard University Press, 2001), 31.

[11] Ibid., 45.

[12] Ibid.

[13] Ibid.

Reconciliation rapidly became an issue of how whites from the north and south would re-establish their respect for and communications with one another. Reconstruction was about social justice, and this required the establishment and enforcement of additional rights for blacks, north, as well as south. However, it was not clear from the outset that there was much of a white constituency for racial equality in the north, let alone in the south. Johnson was aiming for reconciliation with little or no reform, and his plans collided with the Republican reformers who wanted drastic reform as a precondition for reconciliation. In December 1865, Republican congressional leaders gained control of the agenda and refused to seat the southern delegations until their states had passed legislation accepting black suffrage. In 1866, they secured passage of the Fourteenth Amendment, aimed at securing equality before the law for all persons, and then the Fifteenth Amendment, aimed at establishing voting rights for blacks in the south.[14] They also authorized a formal process of Reconstruction, or military occupation, aimed at enforcing societal reform, including the new amendments. Johnson opposed them step-by-step, greatly complicating and ultimately diluting the process of reform. Johnson's opposition ultimately prevailed when, in 1868, his legitimacy to serve as President was challenged by impeachment proceedings, but he avoided removal from office by a single vote in the Senate.[15] Failure of impeachment was an indication of the limits of northern support for reform.

In spite of the Constitutional amendments and a 12-year military occupation of the south (1865–1877), reconciliation won out over reform. Slavery was succeeded by segregation in employment, education, and public accommodations, and the Fourteenth and Fifteenth Amendments were largely nullified in practice in the south. How could this happen in a nation governed by a single set of federal laws? The southern states erected literacy and tax barriers to suffrage and supplemented them with intimidation at polling places, allowing the whites to regain complete political control. None of this was accomplished by stealth; the south received support from the north, both tacit and active. Among the most obvious federal acts of support was the 1883 Supreme Court decision in the Civil Rights cases, striking down the Civil Rights Act of 1875 and ruling that the Fourteenth Amendment did not provide constitutional authority for civil rights laws (which have since been based on the interstate commerce clause).[16] The Court held that the equal protection clause of the amendment applied only to states, i.e., that these issues of equal protection were not subject to federal jurisdiction. Another example of federal aid to discrimination came when Woodrow Wilson was elected President, the first southerner so honored since the Civil War. Known to history as the great liberal reformer,

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[14]Ibid., 107. The Fifteenth Amendment did not establish black voting rights in the north, or prohibit voter qualification tests in the south.

[15]The technical reason for Johnson's impeachment was that he violated a law saying he had to consult the Congress before removing some cabinet officials. Johnson defied this by firing his Secretary of War on his own, leading to the impeachment, which was really motivated by disagreements over Reconstruction policy.

[16]Blight, *Race and Reunion*, 309.

Wilson segregated employment in the US Post Office in May 1913, soon after taking office, and segregated the toilet facilities in the United States Treasury about 6 weeks later.[17]

Historian Charles Patterson confirms this failure to reform the south following the Civil War:

> when the federal government failed to overcome southern white resistance, it lost interest in recreating a new southern society built on racial justice. Reconstruction ended when the last federal troops were pulled out of the South in 1877. The southern white power structure quickly found ways to subordinate and intimidate the former slaves. Whites wrote new laws to keep blacks from voting. These included having to pay to vote (poll tax) and having to read a difficult passage from the state constitution to the satisfaction of the white registrar (literacy test). By the 1890s these requirements had disenfranchised all but a few blacks.[18]

A system of legal segregation grew throughout the south, known as Jim Crow. Such laws were even endorsed by the Supreme Court in the 1896 case of *Plessy v. Ferguson*, where it ruled segregation constitutional so long as facilities were "separate but equal." Legal segregation was then supplemented by behavioral norms of deference enforced by a system of vigilante justice. Between 1897 and 1906, whites lynched at least 884 blacks,[19] or over 80 per year on average, and periodic lynchings continued into the 1950s. There were some racial protests during the first half of the 20th century, producing results in only a few cases. President Truman ended segregation in the armed forces in 1948, but there was still widespread legal discrimination. Patterson notes that, "despite these modest postwar gains, blacks continued to be denied the basic rights of citizenship that white people took for granted. The brutal 1955 murder of 14-year-old Emmett Till in Mississippi—one of thousands of lynchings and unpunished murders of blacks in the south through the years—was proof enough of that denial. In America, blacks were second-class citizens deprived of their most fundamental civil rights—by law in the south, by custom in the North."[20] These circumstances did not change until the 1960s.

Theoretically, the reunification of the US economy via a northern takeover and restructuring of the south would lead us to expect a gradual equalization of incomes within the United States, regardless of or perhaps even because of discriminatory institutions and policies in the south. Laborers would relocate from low-wage (southern) regions to high-wage (northern) regions, and capital would move the other way. Employers managing their workforces on the basis of race and not productive efficiency would, at least in theory, struggle to compete against businesses run along more rational lines. But these presumptions were not borne out, not in the north and especially not in the south. In fact, southern incomes failed to begin converging toward those in the north until the 1940s, and, as Table 9.2 shows, they did not surpass half of those in the north until the 1950s.

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[17] Ibid., 390.

[18] Charles Patterson, *The Civil Rights Movement* (New York: Facts on File, 1995), 2.

[19] Blight, *Race and Reunion*, 344.

[20] Patterson, *The Civil Rights Movement*, 7.

Why the South Failed to Converge After the Reconstruction: 1880–1940

In this section, I argue that the reasons for the south's failure to converge were social, institutional, and ultimately political. I will show how unequal protection of persons, unequal education, and unequal voting rights each enabled the south to sustain its unequal socioeconomic system (albeit in a somewhat different form than the one it held before the Civil War), and how this unequal system distorted and necessarily limited the region's subsequent development.

The most visible carry-over from the antebellum era was the large, rural plantation. In the early post-War period, plantation owners fought hard and successfully to oppose moves to confiscate and redistribute their holdings. As economic historian Gavin Wright has pointed out, sympathetic courts helped bankrupt landowners to avoid foreclosure.[21] On these largely intact plantations, slavery was replaced by a combination of wage labor and sharecropping (under which laborers received a share of the crop). Sharecropping was attractive to employers for several reasons. It required less up-front working capital than a wage-based system (the only initial outlays being tools and seed), it created strong incentives for laborers to remain in one place over time, and ultimately it allowed plantation owners to keep their holdings intact. Laborers who worked hard and won the trust of their employers could aspire to climb the agricultural ladder—that is, to retain progressively larger shares of their output, culminating in a fixed-rate tenancy. While this system offered some prospect for advancement, it tied laborers to particular localities (where their reputation was known) and fostered dependence on local landowners, limiting the scope for many blacks to pursue economic opportunities elsewhere.[22] Recalling the previous chapter's discussion of southern Italy, the plantation-sharecropping system can be seen as another form of clientelism, with its strong vertical ties reinforcing inequalities and limiting the impact of market forces (in this case, labor mobility).

However, not all agricultural laborers in the south became plantation-based sharecroppers. Plantation owners also employed wage labor, and during the last third of the 19th century there was an expansion in non-plantation agriculture (white-owned and rented farms). Given the worldwide cotton glut at this time, why did low-wage workers not migrate to the north? An important reason was that southern out-migration, to the extent it occurred, tended to follow the established pre-Civil War pattern from east to west, rather than from south to north. Moreover, southern blacks were aware that the north had its own segregationist norms, even if they might be less rigorously enforced. As a result, the large outflows of labor that occurred before World War I were comprised of city dwellers and agricultural wage earners displaced by natural disasters. The north's growing need for labor, meanwhile, was overwhelmingly satisfied by immigration from Europe.[23]

Economics professor and historian William J. Collins proposes an interesting interpretation of the data regarding black migration:

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21 Wright, *Old South, New South*, 84.

22 Ibid., 99–107.

23 Ibid., 74–78.

> Whereas only about 535,000 blacks emigrated from the South on net between 1870 and 1910, an overwhelming 3.5 million blacks emigrated on net over the following 40 years, primarily to the urban North. As a result of this exodus, 20.4 percent of blacks born in the South made their homes outside of the region by 1950 compared with only 4.3 percent at the turn of the century.[24]

Collins further notes: "At least until World War I, the economic life of most African Americans was firmly tied to the fortunes of Southern agriculture—in particular to the reign of King Cotton."[25]

But that changed in the years after, when many more blacks began migrating northward. Collins writes that "better-educated blacks were more likely to move northward than those with less education."[26] He also sees an answer to the puzzle of why migration did not occur earlier, considering the higher northern wages; northern wages may have appeared higher, but the competition was stiff, as "the preponderance of European immigrants substantially lowered the expected wage of potential black migrants to the North, at least until the slowdown in immigration during World War I and the subsequent immigration quotas of the 1920s."[27] Collins concludes: "From the analysis of state and city level data, it is clear that on average blacks moved at times and to places where foreign-born immigrants were less prevalent. In fact, the size of the estimated coefficients suggests that the Great Migration would have gotten underway earlier than it did if strict immigration controls had been adopted earlier."[28]

Plantation owners in the south had a clear incentive to prevent black emigration and thereby maintain a good supply of cheap, disciplined, and unskilled agricultural labor. With slavery no longer an option, one way of maintaining their access to cheap labor was to under-invest in education, thereby limiting the mobility as well as the aspirations of workers (Table 9.4). Political developments in the region during the 1890s reinforced this trend. At the time, legislation limiting the vote was adopted in every southern state, effectively excluding blacks as well as many poor whites from the political process. As Wright points out, these reforms were associated with a "virtual assault" on black schools. In Alabama, for example, per pupil spending on whites more than tripled from 1890 to 1910, while spending on blacks fell.[29] This was not purely a political move. It also reflected fears that educated blacks would be more likely to leave the region than uneducated ones.

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[24] William J. Collins, "When the Tide Turned: Immigration and the Delay of the Great Black Migration," *The Journal of Economic History* 57, no. 3 (September 1997): 607.

[25] Ibid., 610.

[26] Ibid., 611. See Robert Margo, *Race and Schooling in the South, 1880–1950: An Economic History* (Chicago: University of Chicago Press, 1990).

[27] Collins, "When the Tide Turned," 617.

[28] Ibid., 629.

[29] Wright, *Old South, New South*, 123.

Table 9.4 Per pupil expenditures as a percent of US average, 1890–1940

	1890	1900	1910	1920	1930	1940
Alabama	28	17	33	39	43	37
Arkansas	40	35	38	34	39	34
Florida	46	51	51	63	58	71
Georgia	24	33	38	33	37	42
Louisiana	50	38	70	65	56	63
Mississippi	32	32	31	32	43	31
North Carolina	20	21	28	38	49	49
South Carolina	20	22	24	30	46	42
Tennessee	27	26	36	35	49	46
Texas	63	56	65	67	63	73
Virginia	47	48	51	54	51	54

Source: Reproduced from Gavin Wright, *Old South, New South: Revolutions in the Southern Economy since the Civil War* (New York: Basic Books, 1986), 80

Similar under-investment occurred in the realm of industry. In many parts of the world, industrialization has been a major driver of economic growth, rising employment and incomes, and modernization. The south began to attract cotton textile producers away from high-wage New England after the Civil War. This accelerated markedly in the 1920s, with the transfer of literally one million spindles to the south.[30] Yet, this process did not result in a regional industrial revolution. Part of the reason was that the south largely attracted low-skill, low value-added industries, relying on northern expertise, capital equipment, and technology. In this regard, the south resembled a colonial outpost of its northern neighbor, a pattern similar to the one we saw in Italy. The region's relatively late industrial development and the absence of any indigenous technological community were also factors.[31]

When southern manufacturing eventually hit its stride (during and after the World War I boom), it failed to result in a lasting improvement in black living standards. Still strong racial prejudices distorted hiring, training, and promotion decisions, with high-skill, better paying jobs going disproportionately to whites. During the 1920s, some black–white wage differentials actually increased, due partly to overt discrimination and partly to the influence of white-only unions in some sectors (e.g., building trades).[32] Just as in agriculture, education was seen as a threat to the supply of unskilled labor in manufacturing; most learning undertaken on the job did not require a more educated workforce.

Economic historian Sukkoo Kim links the south's slow move to industrialization with its slow path toward the income level of the north. Specifically, he argues that regional industry structures can explain the pattern of convergence over time:

[30] Wright, *Old South, New South*.

[31] Ibid., 172.

[32] Wright presents data showing the emergence of a racial wage differential in Virginia in the 1920s. Ibid., 196.

> The most significant cause of income divergence between 1840 and 1900 was the sharp relative decline in Southern income per capita caused by the region's growing unfavorable industry-mix and lower wages relative to other regions. In 1840 about 90 percent of the labor force in the Southern regions was employed in agriculture as compared to 71 percent for the rest of the nation. However, by the turn of the twentieth century the differences widened. In 1900, 82 percent of the labor force in the Southern regions remained in agricultural activities as compared to only 43 percent for the rest of the nation. Because agricultural workers earned less than half of the income of nonagricultural workers throughout this period, the Southern industry-mix toward agriculture lowered its aggregate income per capita relative to other regions.[33]

According to Kim's analysis, "The convergence of regional incomes between 1900 and 1954 was caused by the growing similarities in regional industrial structures and the convergence of regional wages at the industry level." While this may be true for the broad period that he uses, it fails to explain the lack of convergence from 1880 until 1940. The wartime experience, with its labor shortages in the north provided an inducement for emigration north. But there is more to the story than these "natural market forces," as we will see. And his further conclusion that "U.S. regional income per capita continued to converge over the second half of the 20th century due to significant convergence in regional industrial structures" seems to me to show correlation without adequate examination of the circumstances before and after 1940, a circumstance to which I return below.

This brief survey has offered a number of reasons why the south made no measurable progress in closing the income gap with the north prior to the boom brought on by World War II. While southern agriculture and industry had access to the national and even international markets, each was shaped—and indeed distorted—by the persistence of antebellum values and institutions. As in the case of the Mezzogiorno, the lesson is that liberalization, by itself, will not necessarily unify markets or equalize factor incomes; nor will economic growth necessarily result in broadly shared societal gains. Economic inequalities, and the political arrangements that underpin them, need to be taken into account. In the following section, I trace the combination of forces—economic, political, and social—which together made convergence possible beginning in the 1940s.

The Beginnings of Convergence: 1940–1960

Several authors have put forth economic rationales to explain why convergence did not occur until the middle of the 20th century. Collins points to migration as a major factor, Kim sees changing regional industry structures over time, and Barro and Sala-i-Martin together point to the neo-classical economic prediction of regional income convergence. Barro and Sala-i-Martin show that southern incomes converged after 1880, as indicated in Fig. 9.1, finding that "As expected the southern states tended to have low per capita income in 1880 and high average growth

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[33] Sukkoo Kim, "Economic Integration and Convergence: U.S. Regions, 1840–1987," *The Journal of Economic History* 58, no. 3 (September 1998): 672.

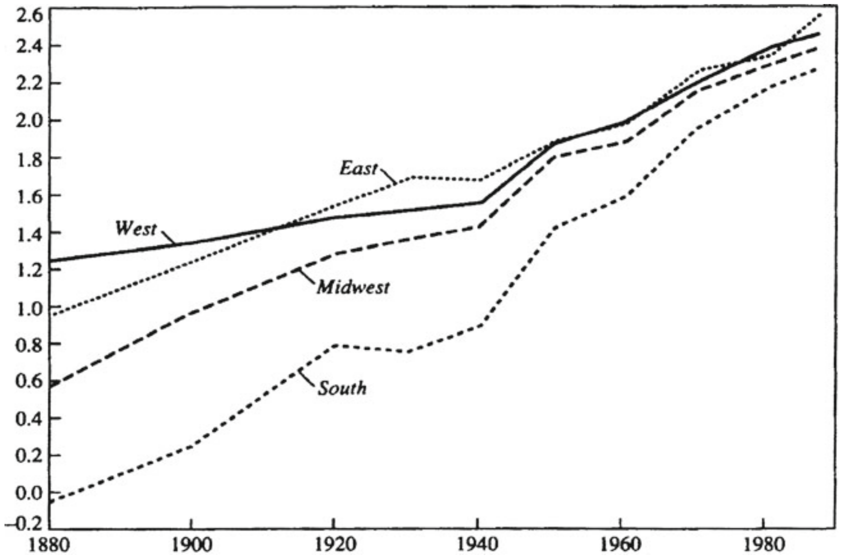

Fig. 9.1 Personal income of US regions, 1880–1988. Note: *Y*-axis shows log of real per capita income. Source: Robert J. Barro and Xavier Sala-i-Martin. "Convergence Across States and Regions," in *Brookings Papers on Economic Activity: Macroeconomics*, ed. William C. Brainard and George L. Perry (Brookings Institution Press, 1991), 124, Figure 5. Reprinted with permission

rates thereafter."[34] They explain the result by noting, "the process of convergence is quickened by movements of people out of areas where ratios of capital to workers are low—and hence wage rates and levels of per capita income are also low—to areas where they are high."[35] However, their explanation does not note, let alone explain, the lack of convergence from 1880 until 1940. True, "the regressions provide strong statistical evidence that, all else being equal, higher per capita income leads to a greater rate of net in-migration,"[36] which in turn fits with income convergence since "the migration of raw labor from poor to rich states speeds up the convergence of per capita income."[37] But their analysis overlooks the fact that relative incomes were the same in 1880 as in 1940, when a process of rapid convergence finally got underway. What needs to be explained is how there could be little or no convergence for a period of 60 years within a market economy characterized by the free movement of capital and labor and a common set of formal institutions, and

[34]Robert J. Barro and Xavier Sala-i-Martin, "Convergence Across States and Regions," in *Brookings Papers on Economic Activity: Macroeconomics*, ed. William C. Brainard and George L. Perry (Brookings Institution Press, 1991), 115.

[35]Ibid., 125.

[36]Ibid., 132.

[37]Ibid., 133.

why it would then change rapidly so as to fit the convergence hypothesis. None of these analyses provides such an explanation.

Gavin Wright points the way to a viable explanation in his discussion of southern economic development when he argues that the underpinnings of the region's distinct economic system were removed during the 1930s. This did not occur spontaneously through market forces, but instead on the basis of policy action by the federal government. With the Democratic Party securing strong majorities in both houses of Congress and a Democratic president in place, it was time for a New Deal.

In agriculture, falling cotton and tobacco prices from 1927 to 1931 resulted in a southern-sponsored program that paid farmers to cut production (implemented through the Agriculture Adjustment Act (AAA)).[38] Given the clientelistic structure of southern agriculture, these payments (at least initially) were channeled through landlords, resulting in widespread allegations of corruption and misappropriation. At the same time, these programs gave landowners an incentive to shift from sharecropping to wage labor, helping to dismantle the tenure system, which had restricted agricultural labor mobility and speeding the introduction of agricultural machinery.

On the manufacturing side, the impetus came from outside the region. First through the National Recovery Administration (NRA) and then through separate legislation (when the NRA was declared unconstitutional), northern labor and business groups pushed successfully for minimum wages and fair labor practices across the country. This disproportionately affected the south, lifting wages closer to those in the north and reducing employment growth, most sharply in the low-wage jobs dominated by blacks.[39]

By limiting local opportunities for the largely unskilled black labor force, these developments opened the way for the massive acceleration of black out-migration that started with World War II. Facing a surplus of labor, southerners encouraged black emigration, even to the point of providing free bus and train tickets northward. The large-scale exodus of blacks from the south dramatically changed the demographics of the United States. In 1940, 80% of US blacks lived in the south; by 1970, this figure had been reduced to 50%.[40] Net migration from the south sharply reduced the supply of farm labor, driving up wage costs and giving impetus to the mechanization of agriculture. As Wright points out, once the mechanical cotton picker had been perfected, it was adopted with alacrity, harvesting over 50% of the American cotton crop in 1960, skyrocketing up from a base of only 6% in 1949.[41] With their dependence on unskilled labor now broken, southern landowners had less reason to oppose education and other social reforms that would take place in future decades. While migrants were moving both ways, the south was a region of net out-migration until the late 1960s, at which time this trend began to reverse.

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[38] Wright discusses the impact of the AAA on sharecropping in *Old South, New South*, 227–233.

[39] Wright, *Old South, New South*, 207–225.

[40] Ibid., 256.

[41] See Ibid., 244, table 8.1.

At the same time that unskilled labor was leaving the south, southern political elites were redoubling their efforts to attract capital and government spending to the region. The rapid increase in military spending during World War II provided an opportunity for southern Congressmen to direct a growing share of patronage contracts to their districts. Eventually, great chunks of defense construction moved south, with warship construction along the Gulf Coast, bomber construction near Atlanta, and the space program divided between Texas and Florida. (Table 9.5 provides further detail on the south's growing share of defense spending.)

In the postwar decades, the south attracted an increasing share of federal government spending, raising its per capita share from 17% below the US average in 1952 to near parity in 1970.[42] As Wright points out, southern state governments aggressively promoted the region to outside investors, offering attractive corporate tax rates and drawing attention to the favorable (i.e., low-wage, less unionized) local business climate.[43]

In the early post-World War II decades (despite the large-scale out-migration), the south was the fastest growing part of the United States. The economic profile of the region was transformed, with a range of new industries (including chemicals, transport equipment, and electronics) gradually supplanting those of the earlier industrial era (like textiles, food, paper, and lumber). Yet, despite these economic changes, much of the south's pre-existing political and social landscape remained in place. The southern states had what amounted to one-party state governments to complement their congressional delegations, which were solidly Democratic. Tax and literacy qualifications to vote limited black opportunities for political voice and thus also limited internal pressure to abolish segregated housing and schooling systems, both of which entrenched unequal opportunities in education and employment.

In this environment, there was no genuine equality before the law, as was evident in the revival of the Ku Klux Klan in the 1960s. While much more limited in scale

Table 9.5 The southern share of population, income, manufacturing value-added, and defense spending: 1960–1998

	1960	1970	1980	1990	1998
Southern share of US population (%)	27.21	27.47	30.00	31.19	32.24
Southern share of US income (%)	20.68	23.22	26.82	27.70	29.51
Southern share of US value-added by manufacturing (%)	17.15	20.67	26.24	29.84	32.24
Southern share of total defense spending (%)	23.41	30.91	30.47	35.82	42.33
Southern proportion of prime Contracts	15.09	25.46	23.46	28.45	37.08

Source: Reproduced from David L. Carlton and Peter A. Coclanis, *The South, the Nation, and the World: Perspectives on Southern Economic Development* (Charlottesville: University of Virginia Press, 2003), 152. © 2003 by the Rector and Visitors of the University of Virginia. Reproduced by permission of University of Virginia Press.

[42] Ibid., 261.

[43] Ibid., 262–263.

than the Sicilian Mafia, the KKK often had the support of the local population, especially in the rural areas. Unlike the Mafia, the KKK was not a criminal enterprise operating various rackets; rather, it was an organized system of local intimidation and vigilante justice, i.e., a continuation of the traditional clientelistic system.[44] This unlawful behavior went largely unpunished, as white juries would usually decline to convict.

The Role of Cultural Revolution in Market Unification

Violations of black civil rights such as these led to the emergence of the Civil Rights Movement in the 1950s and 1960s. The early stages of the movement targeted segregation in education, beginning with lawsuits regarding higher education and later moving down to elementary schools. This stage of the struggle led to the famous 1954 Supreme Court decision of *Brown v. Board of Education* (1954),[45] which overturned the "separate but equal" doctrine from *Plessy* and made segregation in public education unconstitutional.

An organized plan of civil disobedience began to emerge the following year when a black woman named Rosa Parks refused to give up her seat on a Montgomery, Alabama, bus on December 1, 1955. Her arrest sparked a year-long black boycott of the segregated Montgomery bus system, led by the emerging civil rights leader Martin Luther King, Jr., and the boycott won out despite violent intimidation by whites. Under the leadership of King, Montgomery's civil rights activists pioneered the organizational and nonviolent techniques that civil rights protesters would use repeatedly in the years ahead.

The notable step toward establishing black civil rights and altering the socioeconomic institutions of the south came in September 1957 with the start of a new school year at Little Rock Central High School. In order to enforce the Supreme Court's order to desegregate the public high school, President Eisenhower ordered paratroops to Little Rock and began what became one of the early flashpoints in the Civil Rights Movement. Arkansas Governor Orval Faubus had repeatedly obstructed the planned integration, even though the federal courts had ordered that the nine black students involved be allowed to attend class, despite mob protests. Patterson relates this historic event

[44]The KKK was first founded in 1866 to restore white supremacy and act as a vehicle for underground resistance to Radical Reconstruction. In 1870 and 1871 Congress passed bills that allowed authorities to use force in suppressing disturbances and to impose heavy penalties upon terrorist organizations. In 1882 the Supreme Court declared some of the acts passed by Congress as unconstitutional, but by that time the Klan had practically disappeared. It was reincarnated in 1915 by groups who felt threatened by increased immigration and the Bolshevik revolution in Russia. Membership dropped drastically during the Great Depression and the organization was disbanded in 1944. It had a resurgence in the 1960s during the civil rights movement, again to promote white supremacy. President Johnson publicly denounced the organization on national television and the KKK was ultimately unable to stem the tide of racial tolerance. It was never a criminal organization such as the mafia.

[45]*Brown v. Board of Education* (347 U.S. 483, 1954).

> Convinced now that Little Rock was an issue more of insurrection than integration, President Eisenhower ordered riot-trained units from the 101st Airborne Division to Little Rock and mobilized the Arkansas National Guard. He told the country on national television that while it saddened him to have to send troops to Little Rock, he was determined not to allow mob rule to override the orders of a federal court . . . When [the students] arrived [the next morning], hundreds of soldiers with drawn bayonets surrounding the school were keeping the mob back as army helicopters circled overhead. Inside the school, the paratroopers served as bodyguards for the black students.[46]

Though he was a former five-star general who had successfully managed the Allied armies in their victory in Europe only 13 years earlier, Eisenhower did not attempt a broader enforcement of civil rights in the south, and abuses thus remained. Laws do not enforce themselves; it takes public demands and thus cultural support for law enforcement. Eisenhower did not believe that support existed in 1957, nor was he eager to force the matter. He wrote in his diary of July 24, 1953: "I do not believe that prejudice . . . will succumb to compulsion. Consequently, I believe that Federal law imposed upon our states in such a way as to bring about a conflict of the police power of the states and the nation would set back the cause of progress in race relations for a long, long time."[47] As Levy notes

> Up until this moment, President Dwight Eisenhower had avoided the civil rights fray. While he declared his support for the Brown decision, privately he had misgivings about the Warren Court. Eisenhower believed that desegregation could come only gradually to the South, that the federal government could not force racial reform on the region . . . [After Little Rock,] convinced that changes would have to come gradually, without decisive federal intervention, Eisenhower remained on the sidelines. He kept federal forces out of other communities that evaded the law and provided no forthright moral support to civil rights forces. Only through his appointment to the courts of judges who ultimately issued numerous pro-civil rights decisions did Eisenhower promote the struggle for racial equality.[48]

This hands-off approach had little impact on the racially discriminatory system of the south. In 1960, students in Greensboro, North Carolina, staged a sit-in to demand service at a "whites only" lunch counter. The episode made national news, and the movement spread rapidly in the south, with student groups often in the lead. The next year there were organized freedom rides, as northern students went south to continue the civil rights protests. Then, in 1962, James Meredith became the first black student admitted to the University of Mississippi. Amid violent rioting, Meredith needed federal marshals to protect his right to register and finally begin his studies. A year later in 1963, King and other civil rights leaders were arrested and jailed for leading a protest march in Birmingham, which was met with violence. Shortly thereafter Medgar Evers, one of the civil rights leaders, was assassinated in Jackson, Mississippi. And in August an estimated 250,000 demonstrators staged a

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[46] Patterson, *The Civil Rights Movement*, 29–30.

[47] Quoted in James C. Duram, *A Moderate Among Extremists: Dwight D. Eisenhower and the School Desegregation Crisis* (Chicago: Nelson-Hall Publishers), 61.

[48] Peter B. Levy, *The Civil Rights Movement* (Westport, CT: Greenwood Press, 1998), 11–13.

peaceful march on Washington, DC. This was followed a few weeks later by the bombing of a black church in Birmingham, killing four young black girls.

President John F. Kennedy and his brother, Attorney General Robert Kennedy, showed their willingness to go much further than Eisenhower had in their efforts to support the Civil Rights Movement, intervening behind the scenes in some cases with southern governors and in other cases providing marshals to protect demonstrators. But progress remained limited until President Kennedy's assassination that October. When Lyndon Johnson was sworn in as President following the assassination, he recognized a window of opportunity for legislative change, in part as a tribute to the slain president. As a former Senate majority leader and master legislative tactician, Johnson was able to secure passage of the federal Civil Rights Act of 1964 and the Voting Rights Act of 1965, which together finally established the notions of equality before the law and the right to vote. In addition, in a 1965 address at Howard University, President Johnson announced a new approach to civil rights that promised "not just equality as a right and a theory, but equality as a fact and a result. … For the task is to give twenty million Negroes the same chance as every other American. … To this end equal opportunity is essential, but not enough."[49] This became the concept that would drive subsequent "affirmative action" programs in housing, employment, and school and college admissions. (It also had implications for the eventual national movement toward deregulation in the political and economic spheres, as will be examined in Chap. 14.)

While many in the south resisted these changes, southern political and business elites adopted a more pragmatic stance. The local business community, now more closely integrated with the rest of the country, was sensitive to the negative publicity that riots and instability generated. And rural elites, no longer dependent on unskilled black labor, had less reason to block the civil rights agenda, thus opening the way for institutional as well as economic convergence.

By 1966 the civil rights movement had spread north, particularly attracting attention when protestors switched from objecting to slum conditions in large cities to objecting to segregated housing in all-white suburbs. The anger of the suburbanites allowed the protestors to challenge race-based standards in housing, education, and employment there as well. Still, there was occasional violence, and it would require the dispatch of federal marshals and the use of federal courts to see that the civil rights laws were enforced. Perhaps the most memorable act of violence was the assassination of Martin Luther King in 1968. Yet, it was not until a decade later, in 1978, that real institutional change arrived. That year, the Supreme Court upheld the concept of affirmative action in the *Bakke* case, while at the same time overruling the use of quotas, a position reaffirmed by subsequent decisions. Thus, in reality, the US switched from a concept of equality of opportunity to one of equality of results in order to compel institutions to implement the civil rights acts. With this change in concept, backed by the courts, it was finally possible to speak of a convergence of

[49] Lyndon B. Johnson, "To Fulfill These Rights," speech delivered at Howard University, Washington, DC, June 4, 1965. Reprinted in *The Crisis* 72, no. 6 (June/July 1965): 348–353.

institutions between the north and the south. However, in *Bakke*, the Court adopted what would amount to an objective, market-based standard for judging compliance with the Civil Rights Acts. This choice of standards may well have lent unintended support to the broad-based acceptance of deregulation as a standard and the use of market-based outcomes, in preferences to those based more on selective measures.

Table 9.2 indicates that US income convergence reached a high point in 1980, but this may well be due to the fact that US incomes by skill level became much more unequal in the 1980s, a point we return to in Chap. 14. The broader conclusion is that after a combination of cultural revolution and the exercise of federal power, southern incomes had essentially converged to northern levels by 1980, though it is not clear that they have made further progress since then. Since 1970, blacks have been migrating back to the south as a land of opportunity, though at the same time southern spending on public education continues to be far below average. Alabama is a prime example of a southern state under-investing in public goods and governance, as reported in the *New York Times* in 2003:

> Alabama is not a wealthy state, but its bigger problem is that it is not making an effort to raise the taxes it needs. It is 48th in the nation in state and local revenue as a percentage of personal income. . . . And it has the nation's least equitable tax system. . . . Last month, Alabama voted for fewer social services, less education, and a shoddier legal system—to become, that is, more like a third-world nation.[50]

Lessons from the US Experience

The case of delayed north–south regional convergence in the United States is valuable because it calls attention to three different dynamics: first, a century or more of diverging incomes between north and south prior to the Civil War, with the south falling behind; second, a period of about 60 years when southern incomes held even with those in the north but failed to converge in spite of half-hearted reform; and third, a period of income convergence after 1940 and of institutional convergence from the 1960s onward. Only the final period is consistent with simple versions of the convergence theory, yet lessons can be drawn from each of these periods.

First, the United States started out as one country with two systems, one free and one slave. The north was not free just because it was British or Puritan, though these factors were important. The key to its development was in geographic conditions that were not well suited for plantations staffed by slaves, although slavery did initially exist there. The lack of concentrated factor endowments that could be exploited by forced labor was arguably a necessary, though not a sufficient, condition to enable the north to forego the temptations of a system based on forced labor. As Engerman and Sokoloff have pointed out, a lack of concentrated factor endowments permitted, though did not guarantee, a pattern of egalitarian wealth

[50] Adam Cohen, "Editorial Observer: What Alabama's Low-Tax Mania Can Teach the Rest of the Country," *The New York Times*, October 20, 2003. Copyright © The New York Times Co. Reprinted by permission.

and income distribution. This egalitarian pattern of wealth distribution in turn permitted, encouraged, and benefited from the creation of institutions to provide public services such as education, law enforcement, and physical infrastructure for the bulk of the population. These institutional differences would ultimately provide the basis for northern incomes to surpass those of the more richly endowed south. They would also permit a poorly endowed New England to surpass the much more richly endowed areas of the Caribbean and elsewhere in Latin America.

Second, parts of the south had geographic advantages (e.g., soil and climate) that were conducive to plantation agriculture and that initially attracted more immigrants than the areas further north. These geographic advantages induced the widespread adoption of the institution of slavery as a way to exploit plantations that could export high-value crops to the European markets. A production system dependent on slavery became the basis for a social system that concentrated wealth in the hands of a white elite and led to the adoption of institutions that would under-provide education, law enforcement, and infrastructure, i.e., establishing and perpetuating an incomplete state.

Third, the south’s pursuit of its comparative advantages in agriculture became the underlying basis for the creation of a political and social system that impeded the development of its home market, delayed its industrialization and urbanization, and caused the south to fall behind in its relative development well before the Civil War. Failure to develop its public goods (e.g., schools, infrastructure, and law enforcement) left its human resources and basic institutions far behind those in the north. In the long run, these institutional deficiencies would prove far more important than the more obvious geographic advantages in the south.

Fourth, as with the case of the Mezzogiorno, this case demonstrates that market liberalization does not, by itself, ensure market unification. The south remained largely isolated from the north until the 1940s, despite the formal removal of its slavery-related barriers to labor mobility in the 1860s. Even when rapid growth brought an important measure of income convergence in the 1940s and 1950s, this growth did not translate into institutional convergence. The case thus illustrates how market forces are not necessarily strong enough to force the modernization of entrenched institutional frameworks; these frameworks may have to change before markets can bring convergence.

Fifth, again as with the case of the Mezzogiorno, this case shows how narrowly based political elites can be remarkably successful in resisting pressure to change a set of institutions that serves their own interests. While the Thirteenth Amendment abolished slavery, the southern elites were able to use intimidation, vigilante justice, and various other barriers to black suffrage in the south such that the Fourteenth and Fifteenth amendments were effectively nullified for a century. In this context, plantation owners held onto their large land holdings (with the support of sympathetic local courts) and established a new form of clientelistic employment relationship with many of their laborers (i.e., sharecropping). This system deprived southern blacks of remotely equal opportunities for personal development, let alone income convergence with whites, north or south. This meant that there were two or more cultures side by side, north and south, but because of *political* rather than cultural choices. Southerners circumvented constitutional reforms to maintain an exploitative social system into the 1960s, and Jim Crow was thus backed by political power. The one country, two systems scenario would not end until that political power was nullified by the civil rights laws and court decisions of the 1960s, which were backed by the coercive force of the federal government in the form of federal marshals and, in one case, by elite federal troops.

Sixth, though not much discussed in this brief account, there was northern complicity in this underdevelopment of the south because the north, like the south, was run by its white majority, and it, too, was willing to tolerate segregated housing, schooling, and employment well into the 1960s. Indeed, here cultural change was arguably more important than political change; it was only a cultural revolution that transformed the north along with the south and brought a convergence of institutions in the two regions toward a standard that neither had enjoyed previously. This implication has bearings on the case of Italy as well; Alexander Stille was surely right to point out that what Italy needed to cure the problems in the Mezzogiorno was a firm commitment by northerners to end their tolerance of clientelistic corruption in Rome and to the north. The United States was very fortunate that its northerners made such a commitment in the 1960s in response to an extended period of civil disobedience and, likewise, that the federal government had the political power to compel change in the south. However, it should be noted that the commitment of northerners turned out to be to eliminate the immorality of segregation and not the more basic problem of racism.

Seventh, the United States, unlike Italy, did successfully achieve institutional as well as income convergence in the 1960s and 1970s. This convergence seems to have been based first and foremost on sustained public demand for reform for more than a generation, beginning in the mid-1950s. However, segregation presented a clear target of overt immorality. Racism was a much more subtle issue, and one which US society has not been much more successful solving than Italy in terms of acceptance of manifest inequalities and clientelistic relations.

Part IV
The Economic Strategies of Capitalist Systems

Prologue
Economic Strategies

This is a book about governance, and governance is about choices made by political authorities. Whereas the invisible hand can impartially coordinate economic actors within a given framework through maintaining equilibrium, governance implies the power to reshape that framework to suit a particular set of human purposes over the opposition of those who find themselves losers. The visible hand of government automatically implies a strategy based upon human intention; in this it is a near opposite to the invisible hand of the pricing mechanism.

Economic strategy implies the power of a society, through its government, to shape its own institutions and its destiny. This is precisely where one encounters the difference between the two-level version of capitalism, with its institutions allegedly based upon cost effectiveness, as determined by an automatic calculation with little human discretion or agency, and the three-level system, where human intention is involved in the "modernization" or redesign of the system in light of changing circumstances, actual or anticipated, and effected through a legislature or regulatory agency.

Governance choices can shape an economy through direct actions, as, for example, in creating a state-owned enterprise, or enacting a subsidy to promote an activity. However, a more common and, I believe, far more important, kind of government intervention comes indirectly through shaping market frameworks, where no cash need change hands. Market frameworks are shaped by laws and regulations, the former established by legislatures and the latter by regulatory authorities. This is the point made so crucially by Douglass North when he notes that the shape of market frameworks affect the development of economies. The achievement of equilibrium is a way to maintain the stability of a system, but equilibrium does not propel the development of one sector or type of activity relative to another. It is built on the quasi-static notion that markets regulate themselves so long as macroeconomic balances are maintained. Selective choices, reflecting human preferences, are the essence of strategy, and they may or may not appear cost effective in the short run.

Market frameworks can be shaped by government interventions in order to favor producers or consumers, debtors or creditors, stockholders or bondholders, or one sector versus another. Furthermore, if one thinks of policy tilts as related to the priorities of the society in question, then the characteristic tilt of policy interventions should be expected to change over time as societal priorities change. These policy-based interventions are typically made one at a time, and often as a result of legislative compromise among competing political factions, rather than as “grand strategy” in the sense that one imagines for an army fighting a major land war. Nevertheless, these discrete decisions can and typically do have the appearance of a characteristic tilt, which is one of the key characteristics of an economic strategy.

US policies had a characteristic tilt toward producers from the founding of the republic up until at least 1830, when the United States was a developing country, so to speak. Legal scholar Morton Horwitz has pointed out that these policies typically avoided great debate by reshaping property rights in ways that would be implemented by courts rather than through direct subsidies, which would be likely to attract more direct political opposition.[1] David Moss has shown how US policies of “risk management” have had a distinctive and at the same time different “tilt” in each of three time periods, beginning with an emphasis on creating a secure environment for business, and then shifting toward a more secure environment for labor beginning about 1900, with a third period focused on creating a more secure environment for consumers from 1960 onward.[2] Thus, the nature of the policy tilt changed as the country grew richer, reflecting a developmental logic. A society needs to build its productive powers by favoring its producers (business), then its labor, and finally its consumers, once other priorities have been addressed.

Peter Hall and David Soskice, in their *Varieties of Capitalism*, have taken a different approach to the identification and analysis of strategies by contrasting one group of countries that has emphasized the use of its labor markets for influencing development with another that has emphasized its capital markets. Calling the former group of countries the coordinated market economies (CMEs) and the latter the liberal market economies (LMEs), Hall and Soskice find very significant difference in policies (strategies) and also in performance. Since most writing about the English-language countries focuses on how economies are influenced through their capital markets, the identification of the CMEs is a signal contribution and one that should suggest many possibilities for further research. Globalization seems sure to increase the competitive pressures on labor, and, as labor is much less mobile than capital, labor in high-income countries will need protection via some such form of policy intervention if its share of opportunities and incomes is not to fall steadily in the years and decades ahead.

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[1] See Horwitz, *The Transformation of American Law, 1780–1860*, as discussed in Chap. 7.

[2] For the three time periods referred to, see Moss, *When All Else Fails*, 298, Figure 10.1.

In the next three chapters I have taken a different route to the identification of strategies; an approach built more on macroeconomic variables such as trade policies, exchange rates, and fiscal balances. I use three strategies for illustrative purposes; they are well known and suggest what governments can do if they so decide, while outlining some of the risks, as well. The reader will have little difficulty in noticing that the prevailing belief system based on neoclassical economics, which was and is the basis of the Washington Consensus view, has become increasingly associated with a quasi-static view of the world, and thus has a less dominant position in economic thinking than it held a decade ago. However, that quasi-static view has been so dominant that there has been relatively little thinking about the alternatives. That seems likely to change in the years ahead.

If I were starting this section over again, I would give more space to the neomercantilist strategy, which most closely approximates the experience of the East Asian countries. I would also give more emphasis to the coordinated market economy, to explore what a difference it might make to put employee interests higher in a national priority scheme and shareholders correspondingly lower. This would have particular implications for Americans, as the US emphasis on shareholder capitalism has played an instrumental role in creating the most unequal distribution of incomes among industrial countries, as I will explain in Chaps. 13 and 14.

Chapter 10
Import Substitution as an Economic Strategy

Inward orientation, or import substitution as it is often called, is an economic strategy that aims to accelerate economic growth and industrialization by substituting domestic production for existing imports and by forestalling future imports as demand grows. In most countries, inward orientation has been an interventionist strategy that shifted incentives away from agriculture and toward industry. It can be achieved through altering relative prices, for example, by levying tariffs or imposing quotas to restrict external sources of industrial goods. Either form of intervention causes domestic prices of industrial goods to rise and creates additional incentives for domestic investment in manufacturing plant, equipment, and other inputs. Alternatively, inward orientation can be achieved through intervention in the domestic economy to reduce the prices received for agricultural produce and/or to subsidize production of industrial output.

The Economic Logic of Import Substitution

Import substitution aims to shift the relative profitability of manufactures and agriculture, typically by imposing tariffs or quotas on the former. This leads to a rise in relative prices of the protected products in the domestic market, a rise in the prospective returns from their manufacture within the local economy, and a decline in the profitability of agriculture, as farmers must pay more for their industrial inputs. Thus, in addition to promoting investment and growth, this strategy should also promote a shift in the structure of the economy. Consider the following example, where there are two sectors, agriculture and manufactures, and their profitability is expressed relative to the cost of capital within the country, as in Fig. 10.1.

As shown stylistically in the figure, most of the agricultural sector is earning returns that are far above the hypothesized cost of capital, and most of the manufacturing sector is not. As a consequence, there should be little investment in or growth of the manufacturing sector. An import substitution strategy, based upon tariffs or quotas, should raise the price of imported manufactures, while reducing manufactured imports. Higher domestic prices should lead to higher financial returns in manufactures, as indicated in Fig. 10.2. This, in turn, should induce new

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_10,

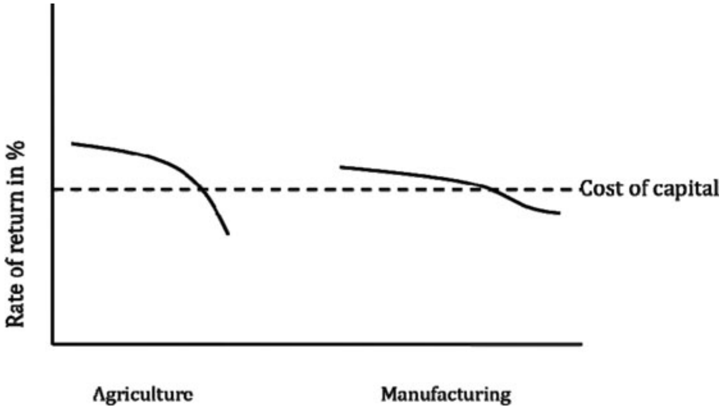

Fig. 10.1 Relative profitability of agriculture and manufactures prior to imposition of strategy. Source: Bruce R. Scott

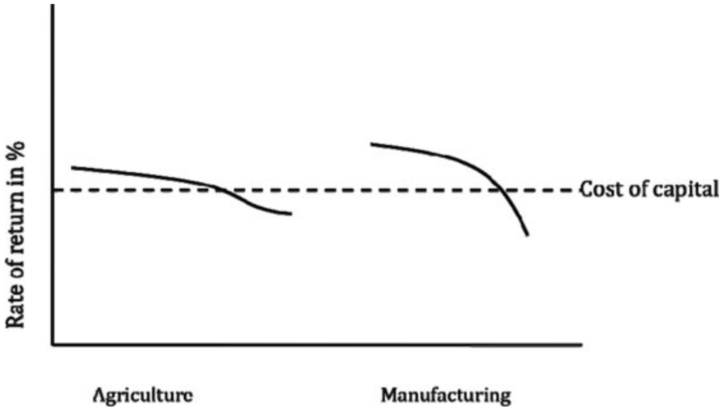

Fig. 10.2 Relative profitability of agriculture and manufactures after imposition of strategy. Source: Bruce R. Scott

entries in the domestic industry, while inducing increased domestic production. At the same time, it should lead to higher costs of manufactures purchased by farmers and a decline in their returns from agriculture, again as indicated in Fig. 10.2.

Whereas a similar effect could be achieved through direct subsidies of manufactures by government, the cost of these subsidies would require increased taxes and/or borrowing by government, something that most governments in poor countries are anxious to avoid. It would also open opportunities for favoritism of some producers over others and, likely, corruption. Government can limit its own role in this strategy by altering market prices through import restraints in lieu of the payment of subsidies, forcing consumers to finance this strategy through their purchases. However, this form of intervention distorts domestic prices relative to those in external markets.

If the level of protection is too low, there may be little or no response from potential entrepreneurs. If it too high, there may be numerous new entrants, all of which are small and inefficient, and possible over-capacity as well. In order to gain the advantages of specialization in small markets, it became common to accompany this strategy with a requirement of a permit or licenses to enter a protected industry.

While this strategy can be easily implemented, it has often been associated with unintended side effects, such as increasing domestic prices, inflation, declining exports, and overvaluation of the currency. The World Bank included import barriers, domestic controls, and unintended side effects in its definition of strong inward orientation:

> an incentive structure that strongly favors production for the domestic market. The average rate of effective protection for home markets is high and the range of effective protection rates relatively wide. Direct controls and licensing disincentives to the traditional export sector are pervasive, positive incentives to nontraditional exportables are few or non-existent, and the exchange rate is significantly overvalued.[1]

Growth is fostered by the additional investment and jobs in manufactures and by the transfer of labor from underemployment in agriculture to more productive employment in manufactures and services. The losers in this incentive scheme are small-scale farmers as well as some large-scale farmers. Since agriculture may not attract much foreign capital, there may not be much of a loss in foreign investment in this sector. On the other hand, the shift in incentives to favor industry should attract additional investment from abroad, thus adding to the available capital stock and boosting productivity.

While inward orientation can be traced back to the 15th century if not earlier, it became particularly popular during and after World War II. The War shut many countries off from external sources of important industrial goods, giving them a choice of making such goods or doing without. In such a context, this became a strategy to reduce the need for rationing. However, in the context of postwar decolonization, inward orientation acquired a very important political rationale as well, as a popular way to assert newfound independence. India, for example, had been subjected for decades to a foreign trade regime in which the country was a source of raw materials for Britain and a protected market for its manufactured exports. India's prewar independence movement, under the leadership of Mohandas K. Gandhi, had used manufactured imports as a symbol of oppression. Gandhi took to wearing homespun clothing as a symbol of resistance and, in several demonstrations around the country, his followers threw their imported clothes into huge bonfires in symbolic support of domestic producers. Independence was a chance to establish autonomy and control of domestic affairs, and inward orientation was a strategy for using control of the domestic market to build an independent and more powerful state, while promoting industrialization and economic growth.

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[1] World Bank, *World Development Report 1987: Barriers to Adjustment and Growth in the World Economy; Industrialization and Foreign Trade; World Development Indicators* (Oxford University Press for the World Bank, 1987), 82.

Two developments in economic theory lent tangential support to this strategy. The wartime experience of both Britain and the United States had shown that economic growth could be stimulated by government spending, eventually absorbing all of the unemployed in the domestic labor force, as predicted by the new macroeconomic model of John Maynard Keynes. Meanwhile, development economists had come up with the notion of a "big push" as a way to stimulate industrialization in less-developed countries. The key to development was to boost investment, which would create additional demand for all sorts of goods and services and thus fuel economic takeoff. Given the general prosperity in the world economy until 1974, there was widespread optimism that many, if not all, of the emerging economies could prosper with the assistance of interventionist strategies where government stimulated demand and/or investment through this strategy.

However, inward orientation was not confined to recently liberated colonies or less-developed countries. Australia, Canada, and New Zealand were also important models of high-income agricultural economies that intervened in their markets to subsidize industry at the expense of agriculture, while South Africa was a successful example of a middle-income country using a similar strategy. Furthermore, immediately following World War II, France was an unlikely user of the import substitution model. France's 5-year plans, elaborated by a National Planning Commission, assisted by the inputs of some 3000 participants drawn from the business and governmental elite, were focused on balancing supply and demand in the domestic market in the face of a continuing shortage of foreign exchange.[2] And, prior to World War II, the United States had also protected its industrial sector, beginning with Hamilton's tariffs on industrial imports as a way to finance the servicing of the national debt. While the United States might be said to have used such a strategy for more than a century of successful growth, after a few decades of economic growth it did so from an exceptional position as one of the world's largest markets. In these exceptional circumstances it could limit foreign imports of manufactures, while domestic manufacturers could nonetheless aim for considerable economies of scale.

The Dynamics of Import Substitution Change Through Time

As with warfare, the dynamics of inward orientation can and do change through time. Import substitution begins with a clear economic rationale that can yield important benefits at relatively low cost, but the costs are likely to rise dramatically relative to the benefits over time. The increased inefficiencies result from the changing mix of industries being promoted, the expanding economies of scale required for efficient operations, and the impossibility of achieving efficient scale. Bela Balassa, a noted economist who served as an advisor to the World Bank, was a pioneer in

[2] See Bruce R. Scott and John H. McArthur, *Industrial Planning in France* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1969).

distinguishing two phases of the inward-oriented strategy. This distinction between two phases of a single strategy was of seminal importance. According to Balassa,

> All developing countries pass through a first, or easy, stage of import substitution, entailing the replacement of imported nondurable consumer goods and their inputs by domestic production. The domestic manufacture of these products, such as textiles and clothing, leather and shoes, and wood and furniture, is well suited to the conditions governing production that exist in most developing countries. Their manufacture involves largely the use of unskilled labor, does not require sophisticated technology, and the optimal scale of production is low, with production costs not being substantially higher in below optimal size plants. (As a consequence), developing countries can undertake the manufacture of these products at relatively low costs, and their establishment requires but moderate infant industry protection.[3]

Initially, small production volumes for small markets are not much of a handicap, as unsophisticated technology and small-scale facilities mean that fixed costs are low. Cost differences between domestic and foreign producers of simple goods are small, even though foreign producers may produce in much greater quantities. In industries such as textiles, leather goods, wood products, and the canning of food products, there is ease of entry, and small-scale investments do not require recourse to external financing. Local entrepreneurship and local capital are largely sufficient to meet domestic demand. Consumers of these manufactures pay higher than world market prices, but not much higher, as the losses in scale economies are not large relative to the transport and inventory savings from local production. Following Balassa's argument further: "During this stage, industrial production can rise at a pace exceeding the growth of domestic demand for nondurable consumer goods since it is replacing imports as well as supplanting them."[4] For instance, locally made shoes might replace imports and obviate the need for imports as demand rises. Shoe production should then grow more rapidly than demand and more rapidly than GDP, rendering shoes a "leading sector" or an "engine of growth."

This analysis applies with little change to middle-income nations (South Africa and Venezuela) and high-income nations (Australia and New Zealand). Australia, for example, launched import substitution between 1901 and 1907, when it had the highest incomes in the world.[5] At that time Australia was the world's leading exporter of wool. Farmers effectively subsidized manufactures by paying higher prices for their supplies and equipment in the local market. Argentina and Sri Lanka added a more targeted approach, utilizing export taxes on beef in one case and tea in the other to supplement tariff revenues, while distributing much of the proceeds through government transfer payments.

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[3] Bela Balassa, "Developing Country Experiences in the Postwar Period," in *In Search of an Economic Strategy* (Caracas: Mimeo, Dividendo Voluntario para la Communidad, 1985), 39.

[4] Ibid., 40.

[5] See Ian Marsh, "The Prospects for Australian Political Realignment: 1888 Revisited," in *Australia Can Compete: Towards a Flexible, Adaptable Society*, ed. Ian Marsh, Research study (Committee for Economic Development of Australia) (Melbourne: Longman Cheshire, 1988).

Many developing countries added a regime of domestic price controls and subsidies as well. In Africa, for instance, it was common to have an agricultural marketing board to control the export of cash crops. While some of these boards had begun as producer-organized associations focused on offering higher prices in export markets, they were converted to inward orientation and so reduced the prices that they offered to domestic suppliers to well below world price levels in order to shift the relative prices of agricultural and industrial products. The proceeds were then used to subsidize food costs for urban areas, thus permitting lower wages and again subsidizing industry. Domestic prices in these schemes ranged roughly from 50 to 80% of world prices.[6]

In both approaches, the rural producer (of agricultural goods) was paid less than full market value and thereby subsidized domestic manufactures, importers, and urban consumers. While there were typically far more rural voters than urban, the latter were typically more active politically than their rural counterparts and much more of a threat to the stability of the regime. Urban rioting could flare up and lead to the overthrow of a regime; in contrast, the rural population was much more difficult to organize and easier to intimidate. Furthermore, if some of the proceeds from the higher incomes were used to subsidize agricultural projects, such as with low-cost water or fertilizer, these benefits could be targeted to those loyal to the regime, thus breaking up the prospects for a solid rural opposition. But physical intimidation was also a regular part of such a strategy.[7]

At some point, however, domestic producers end up making as many shoes, textiles, and pieces of furniture as their society needs. What then? A country can continue this same process to what Balassa has called Phase II—developing consumer durables and industrial intermediates—or it can switch to the outward orientation, emphasizing increased specialization and trade. This export-oriented option is easy to identify and intuitively attractive but has proven exceedingly difficult to accomplish, for reasons I explore in Chap. 12. In these circumstances most inward-oriented nations eventually embarked on Phase II, even with its increasing inefficiencies. Balassa explains this shift from Phase I to Phase II:

> Once the first stage of import substitution has been completed . . . maintaining a high rate of industrial growth necessitates moving to a second stage of import substitution or embarking on the export of industrial products. In the first eventuality, imports of intermediate products, machinery, and durable consumer goods are replaced by domestic production; in the second, the exportation of commodities whose domestic manufacture was established at the previous stage is undertaken. . . . Once the easy stage of import substitution is passed, replacing imports with domestic production will entail rising costs. This is because the products to be replaced at the next stage, in particular various intermediate products and durable producer and consumer goods, have higher technological and skill requirements,

[6]Robert H. Bates, *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies* (Berkeley: University of California Press, 1981), Appendix 2.

[7]Bates, *Markets and States in Tropical Africa*.

> are relatively capital intensive, and need materials, parts, and components from other industries. Also, large-scale economies are of importance in these industries, and unit costs are substantially higher at lower output levels.[8]

It is at this point that nations with small home markets are trapped. Small home markets can accommodate only a few producers, each with excessive product diversity, short runs, high costs, and high prices. Venezuela and Australia, for example, had three and five auto plants respectively for populations of less than 20 million; Argentina had seven auto plants for 25 million people; and Uruguay, incredibly, at one point had ten auto assembly plants for its 3 million people. Production runs, even for popular items, could be 10% or less of those in Germany, Japan, or the United States. With high costs on short runs, high levels of domestic protection were required for viability in these home markets, and there was no hope for competing in export markets.

For consumer durables and industrial intermediates (e.g., steel and chemicals) that are produced in small economies, domestic demand is likely to be far below the volumes needed for a plant to reach a scale that can be internationally competitive. Costs will naturally be higher, and prices higher still, with additional protection needed to remain competitive with external suppliers. The effects will snowball. Domestic manufacturers buying from one another at high prices become less competitive, requiring yet more protection. A self-reinforcing spiral of declining competitiveness, increased protection, increasingly distorted markets, and lower growth ensues. Most governments in this position were tempted to respond with increased spending financed by increased borrowing from foreign banks and development agencies as a way to maintain moderate, if not always strong, growth. Since

Table 10.1 The phases of inward orientation

	Phase I	*Phase II*
Interventions to promote industrialization	Restrict manufactured imports Tax/control agricultural exports	Phase I plus overvalue currency and ration selectively
Industries	Textiles, leather goods, wood products, processed foods	Consumer durables, industrial intermediates, steel, chemicals, capital goods
Plant size/Economies of scale	Small	Medium-large
Technology	Low-medium	Medium-high
Capital required	Low	Medium-high
Ownership	Private sector entrepreneurs	Family conglomerates, SOEs, multinational firms
Market opportunities	Domestic	Domestic, permits required Buy out other firms

Source: Ideas drawn from an unpublished and undated paper for the World Bank by Bela Balassa

[8] Balassa, "Developing Country Experiences in the Postwar Period," 40–49.

in fact most developing countries had small markets, thanks both to their small populations and to their limited purchasing power per capita, countries practicing import substitution almost inevitably came to be characterized by Byzantine webs of governmental regulation and rising levels of price distortion in their home markets.

Industry Structure and the Ownership of Firms

The potential for gross inefficiencies—like ten auto plants in Uruguay—can be mitigated by requiring permits to enter new businesses. On the one hand, the fewer the entrants there are, the greater the scale of the firms can be. But on the other hand, the fewer competitors there are, the greater the risk that they will collude to raise prices. To counteract the potential ill effects of industry concentration, governments frequently imposed price controls to supplement the permits. This combination of permits and price controls created a context where profits could be more dependent on a firm's relations with government than on effective management of its own responsibilities. Inward orientation in this way creates ever-expanding opportunities for corruption, and the longer the strategy is continued, the greater the likelihood that firms and public officials will discover and exploit those opportunities.

At the same time, increased scale requires increased capital resources, which raises issues of financing, ownership, and control. Many local entrepreneurs cannot amass the funds to build an auto, steel, or chemical plant. Given the small or nonexistent capital markets in most developing countries, floating debt, let alone equity, is not an option. The alternative is negotiated bank debt, with equity from existing sources of wealth, i.e., rich families, foreign firms, or the state. But each of the sources of equity has its political implications, and domestic banks are also subject to government influence if not government-owned.

Family-controlled conglomerates are common in developing countries and are often politically powerful as well. Rich families are a prime source of capital to finance medium- and even large-scale plants and enterprises. In addition, they are well placed to build relationships with government officials and thus to secure the needed permits. And, once established, their scale and status gives them an advantage over smaller firms in seeking licenses from foreign firms. They are well placed to grow by using the cash flow from existing activities to help subsidize the meager returns often associated with breaking into a new business, and they can diversify business risk within the structure of the firm. In addition, through effective lobbying they can reduce those risks as well. Protected local markets can yield unusual profits; a license to operate in a protected environment is effectively the right to "tax" domestic consumers. And the greater the protection, the greater the potential for profit.

Inward orientation tends to concentrate economic power and to thereby increase the linkages between business and politics. Rich families' contributions to political causes are linked to requests for protection and licenses. "Government relations" officers often become the key to profitability as well as new business development.

In some countries, business and government leaders reached understandings that firms and their controlling shareholders would be allowed to make generous profits in return for "staying out of politics," i.e., for allowing political leaders to build their own power through political patronage schemes. Since these patronage regimes tended to favor urban voters, they illustrate the process of corruption earlier noted by Huntington in Chap. 4.

Foreign ownership is a financing option that avoids some of these problems while inviting others. Foreign capital can help assure access to technology, skills, and even brand recognition. And a foreign firm might achieve economies of scale in a small market if it created a specialized plant to export to other markets. For example, an auto assembler might import engines for the domestic market and export an offsetting value of bumpers for the world market. Economies of scale in engines might be achieved at a foreign plant, economies of scale in bumpers domestically. But this typically presupposes government involvement to establish an offset agreement. Of course, such agreements are subject to politicization and corruption in the domestic context, as well as to external pressures for free trade with the external market and thus the prohibition of such offsets. Finally, there is the issue of potential foreign influence on the domestic economy and on domestic politics.

Given the spread of inward orientation immediately after World War II, it took root in many countries as they were shedding colonial regimes and attempting to build their own political and bureaucratic structures, or states. While Phase I called for small, entrepreneurial firms, Phase II supported much larger firms. State-ownership was a natural choice, especially since the control of economic power would add to the political power of the state. State-owned enterprises (SOEs) in utilities and basic intermediate goods such as steel were a natural way to control the "commanding heights" of their economies.

The Resource Bonanza

Thus far our concerns have been for countries without rich factor endowments. However, many countries that adopted the import substitution strategy faced an additional structural factor not mentioned thus far, specifically, the "problem" of having a super competitive resource sector or a "resource bonanza." While initially such sectors were in agriculture, for example, wool in Australia and New Zealand, coffee in Ghana, or rubber and palm oil in Malaysia, in the post-World War II era they arose in oil and other minerals, sectors that created similar but even more acute challenges. First, there were opportunities, as, for example, in Venezuela, where oil accounted for more than 90% of exports following the price increases in the 1970s. With a supercompetitive oil sector, Venezuela could import a wide variety of consumer goods and support a high standard of living. Furthermore, oil production generated large royalty and tax revenues for government, allowing the latter to spend considerable sums for the development of public works and public employment. However, the flip side of the export earnings from oil was an exchange rate that was overvalued for almost all of its other tradable goods, and, as a result, they required

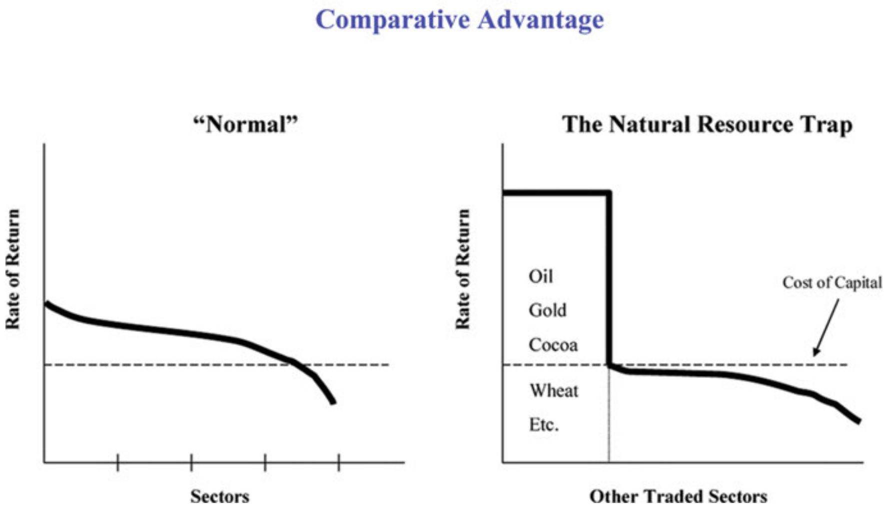

Fig. 10.3 Comparative advantage. Source: Bruce R. Scott

some form of protection from cheaper imports. At the same time, almost all sectors except for oil were shut out of export markets.

Venezuela is a famous but extreme case of a resource bonanza. The generic problem can be illustrated in Fig. 10.3. Whereas a "normal" distribution of advantages, if such exists, might look like the left side of the figure, the existence of a resource bonanza would reshape the curve to look more like the right half. Indeed, if a country had an existing profile as suggested by the normal distribution of advantages, the discovery of a large quantity of oil could cause its profile to shift rapidly to the bonanza distribution, thereby dramatically reducing expected returns in all other sectors exposed to foreign competition. Such a change might well cause radical cutbacks in investment and indeed employment in most existing sectors exposed to foreign competition, with a much smaller increase in employment in oil.

The significance of a resource bonanza on more normal industrial trade can be gauged by examining two exhibits on relative competitiveness of industries in Norway in the early 1980s. As always, the devil is in the details. As shown in Fig. 10.4, Norway had a number of sectors with positive returns for investors. At the time, inflation was high, and the risk-free money rate in London was about 12%. Industries above that line had what might be considered a positive rate of return relative to the cost of capital, assuming the latter to be the risk-free rate. But if one assumes that the true cost of capital should include an adjustment for risk, then it seems likely that at this time there were only four sectors with returns that were above the risk-adjusted cost of capital.

However, investor returns were calculated after royalties to government as well as after subsidies from government. If one strips out the unusual taxes paid to government and subsidies paid by government, then the true social returns resemble those in Fig. 10.5. In this second perspective, the returns from oil and gas are higher,

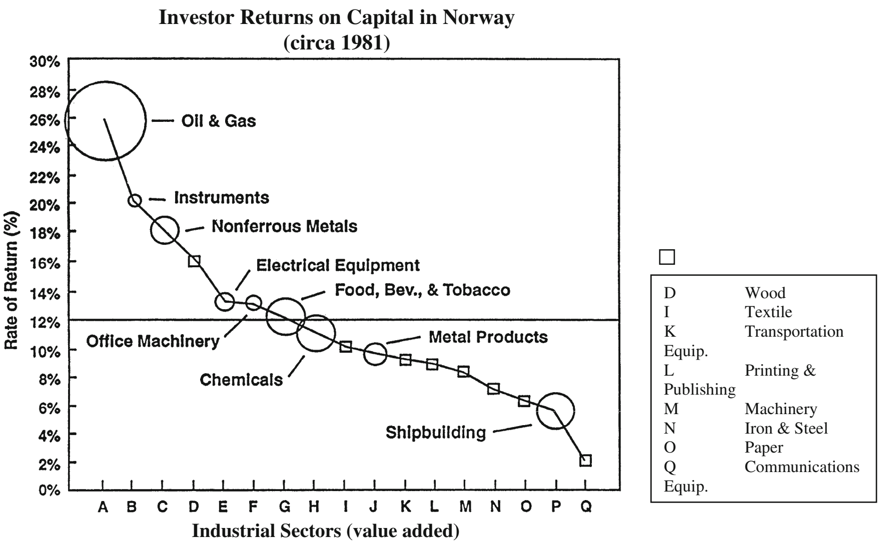

Fig. 10.4 Investor returns on capital in Norway (circa 1981). Norway had a number of sectors with attractive returns for investors. Source: Adapted from F. Nielsen et al., "The Decline of Manufacturing in Norway," Harvard Business School MBA Report, 1983

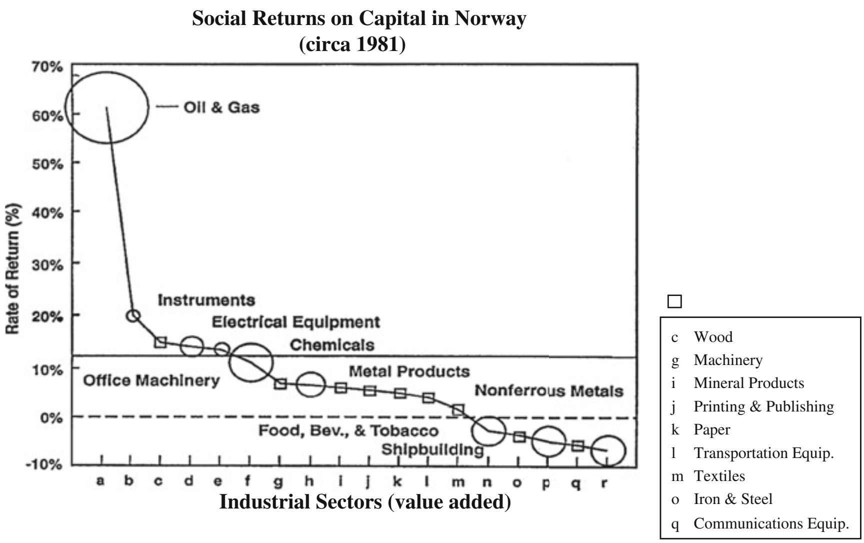

Fig. 10.5 Social returns on capital in Norway (circa 1981). Norway had only two sectors with attractive social returns. Source: Adapted from F. Nielsen et al., "The Decline of Manufacturing in Norway," Harvard Business School MBA Report, 1983

reflecting the unusual taxes paid; the instruments sector might be profitable on a risk-adjusted basis; and all other sectors are failing to earn their cost of capital. The early 1980s was a period of high oil prices, which would come down sharply in 1986, but which, in the meantime, placed about 15 sectors in doubtful financial positions absent financial help from government. Such situations arise in many of the countries with import substitution strategies. The supercompetitive sector may be coffee, cocoa, wool, gold, or iron ore, but their common characteristic is that the exports are constrained by natural factors (such as suitable land or sub-surface minerals), and hence have a supernormal margin in some circumstances.

The Role of Government

A resource bonanza provides an almost irresistible temptation for government to take on new functions because the country "can afford it." Indeed, a democratically elected government with an oil bonanza risks voter rejection if it is not sufficiently ambitious in its promises of what the unusual wealth will do. If it fails to spend, and perhaps to borrow to spend even more, promising to pay off its bonds with future wealth, it is at risk that a demagogue will win power by making just such promises at the next election.

At the same time, the unearned income from a resource bonanza provides the revenues to permit excess employment in government and the creation of a patronage regime to enhance the role of a ruling party. Further, it provides the possibility for government to have increased flexibility in providing subsidies and increases the temptation to provide those subsidies to the friends of the regime.

It also creates the temptation for public ownership of the resource and to thereby again enlarge the scope of the public sector. Public ownership and control is a way to enhance the power of the state and therefore has strongly attracted many political leaders, and particularly those in states that achieved their independence after World War II. This approach to state building is fraught with temptations to manage the so-called commanding heights of the economy more for political purposes than economic ones. SOEs can charge less than market prices in politically sensitive sectors (e.g., electricity, domestic oil prices, foods, and drugs); they can establish facilities in politically sensitive districts, even if more cost-effective alternatives are obvious; and they may enter prestige businesses to enhance the status of a party or government, even if the enterprise is a sure money loser. All such enterprises create a basis for patronage jobs, with tendencies for overstaffing. SOEs can therefore facilitate the large-scale waste of resources. Credit-financed SOEs need to borrow more than comparable private firms, and they are likely to place an extra burden on available savings, raising costs for other borrowers. Governments have typically responded to public enterprises' rising pressures for credit by imposing "credit guidance" on banks, affording SOEs priority access to resources.[9] This process of

[9]France practiced this form of capital rationing in the 1960s as part of its inward orientation. See McArthur and Scott, *Industrial Planning in France*.

providing subsidized finance to favored firms can be expected to lead to an excess demand for savings and either a need for credit rationing or recourse to external borrowing.

This often worked well in the 1960s and early 1970s, as a rapidly growing world economy seemed to justify the extension of additional credit to developing countries. In addition, new multilateral organizations, such as the World Bank and regional development banks, were established to facilitate just such lending. Then the 1973–1974 oil price increases generated surplus savings for the OPEC countries, creating the opportunity for commercial banks to "recycle" those savings to needy borrowers, for example, in Latin America. The full implications of these dynamics would not become widely appreciated until the debt crisis of 1981 and the drastic curtailment of access to credit for many developing countries. Thus, growth rates in Latin America since 1980 have failed to match those of the 1960s and 1970s, because the latter were dependent upon unsustainable increases in foreign debts.

Government's role in inward-oriented regimes has been pervasive and has tended to increase. It has been justified in part by the need for state building, and in the mid-20th century was compatible with both populist and socialist orientations as well as both authoritarian and democratic regimes. Regulations, budgets, and public employment all became ways to wield power.

Except in the former Communist regimes, inward-oriented strategies were present in market economies that had been subjected to very substantial intervention. For instance, tariffs raised market prices for the affected products, while overvalued exchange rates reduced the apparent landed cost of imports. But agricultural marketing boards also controlled prices and split their sales revenues between subsidies to consumers, tax revenues to governments, and political patronage to members of the ruling party and its allies. Much depended upon the overall finances of the government.[10] Newly independent countries had ambitious budgets for infrastructure and for enlargement of the bureaucracy, aiming to build a political machine as well as perform their official functions. Ambitious spending often invited large deficits that tended to be inflationary. The latter led to implicit overvaluation of the currency, further depressing income from traditional exports such as agriculture. Overvaluation, in turn, invited more selective import control, more regulation, and more corruption. All of these trends promoted the tendency to sell outside formal markets, i.e., to establish a black market.

How could this spiral of distortions, waste, and corruption go uncorrected, if not by governments, then by their international creditors? Inward orientation became fashionable at about the same time as Keynesian economics, and the two were symbiotic. For many inward-oriented countries, "Keynesian" demand management became an engine of growth. Since Phase II was likely to lead to an economic slowdown, additional government spending to boost domestic demand was an almost "irresistible temptation." Deficits, excessive credit creation, and inflation all invited additional intervention. What was needed was foreign credit to support both the

[10] Bates, *Markets and States in Tropical Africa*.

foreign exchange shortages and the budget deficits. Foreign governments and multilateral organizations such as the development banks were ready to supplement the lending by the commercial banks. Indeed, the World Bank switched its internal management system from one based on helping countries help themselves to one of transferring capital to close an "investment gap."[11]

Rising domestic prices might have been offset by a declining exchange rate, thus maintaining a rough balance of trade based upon market forces, but typically they were not. Instead, governments restricted imports still further and contributed to significant overvaluation of the currency. In this context, domestic producers experienced declining competitiveness in export markets and were often forced to curtail exports, except in such areas of natural advantage as oil, cocoa, gold, etc. The process was one of spiraling market distortions and increasing inward orientation. Balassa explains:

> Under inward-orientation, exchange rates were often overvalued, with the degree of overvaluation varying from time to time as intermittent devaluations caught up with domestic inflation, thereby creating uncertainty for exporters. Variations in protection rates had similar effects, while inter-industry differences in protection led to distortions [in profitability] and inefficiencies in resource allocation. . . . Price controls were initially designed to counter the monopolistic advantages of domestic producers in highly protected markets, but they often became instruments of social policy, with adverse economic effects. Thus, controls on food prices, designed to keep living costs low for city dwellers, tended to discourage agricultural production while controlling the prices of public utilities gave rise to deficits in the accounts of state enterprises.[12]

In Latin America, related logic was employed in social legislation, such as a minimum wage to protect urban dwellers. It was common for governments to mandate wage increases to offset the inflationary impact of devaluations, thus nullifying any compression of urban incomes. Seniority rules and large severance payments also gave rise to rigid employment structures and discouraged hiring in the formal economy.

But governments added to these distortions by creating others in the credit markets. In general, when government and its SOEs become the leading borrowers, the former is tempted to reduce borrowing costs by controlling interest rates. Real interest rates were thus often negative in the 1970s, subsidizing borrowers and penalizing savers. Savings tended to migrate out of banks and into the informal economy, the real-estate sector, or out of the country. This reduced capital availability for more productive activities, thereby increasing the pressures on governments to impose credit guidance or allocation systems, further politicizing the economy, and retarding development of local financial institutions and capital markets. At the same time, high nominal interest rates tempted borrowers to look offshore for funds at lower rates.

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[11] See William Easterly, *The Elusive Quest for Growth* (Cambridge: MIT Press, 2001).

[12] Bela Balassa, "Developing Country Experiences in the Postwar Period," 41.

With little investment aimed at export development, there was increased dependence on foreign funds to finance growth. Foreign capital was financing domestically oriented, overstaffed firms, and the consumer subsidies implicit in their below-market prices. This was viable so long as external capital markets remained open and as foreign aid and official lending continued. With the credit crunch in 1981, access to external credit was drastically curtailed in many poor countries and a crisis ensued. It was virtually the end of an era for the import substitution regimes.

Performance

Nations that adopted inward-oriented strategies often performed well, by historic standards, during the 1950s and 1960s. At the same time, their performance compared unfavorably with that of a very select sample of countries that had shifted to outward-oriented strategies. Part of the explanation for their poor relative performance was to be found in contextual factors. Most inward-oriented countries had low to middle incomes, small populations, and small to very small home markets. In 1990, only nine countries had 100 million or more inhabitants (China, India, Russia, the United States, Brazil, Japan, Indonesia, Pakistan, and Nigeria).[13] And in terms of purchasing power, developing countries' home markets were often much smaller than suggested by their population. In 1990, the Netherlands had a population of 15 million yet had a larger economy, adjusted for purchasing power parity, than countries with larger populations, such as Pakistan, which had a population of 114 million, and Nigeria, which had a population of 87 million. Similarly, Spain, with 10 million people, had a PPP-adjusted GDP of about $475 billion in 1990, far greater than that of sub-Saharan Africa (excluding South Africa) which was composed of approximately 35 nations and 350 million people. Thus, in broad terms, most countries which followed the inward orientation after World War II did so in the disadvantageous context of a small or very small home market. The importance of this one fact was not fully appreciated until much later. A strategy that promised accelerated growth was able to deliver for a while, often measured in decades and, in some cases, much longer. But over time, its dynamics proved self-defeating, especially for small countries.

Illustrative data can be drawn from an analysis of 11 semi-industrial nations studied by Balassa et al. Eight inward-oriented nations enjoyed positive growth in per capita incomes in the period 1953–1973, but their growth was less rapid than that of the three outward-oriented countries (Korea, Singapore, and Taiwan). A key difference (Table 10.2) is the growth in value added in manufacturing. In the period 1963–1973, Korea and Taiwan reported more than 20% compound growth rates, and Singapore reported 15%. No inward-oriented country reported a comparable rate despite deliberate promotion of manufactures. Outward-oriented countries also

[13]The World Bank, *World Development Report 1992: Development and the Environment* (New York: Oxford University Press, published for the World Bank, 1992), Table 1.

Table 10.2 Growth in per capita incomes in 11 semi-industrialized economies

	Argentina	Brazil	Chile	Colombia	India	Israel	Korea	Mexico	Singapore	Taiwan	Yugoslavia
Per capita GNP											
1953–1960	1.2	3.4	0.4	1.3	1.6	4.8	3.0	2.8	n.a.	3.2	4.4
1960–1966	2.1	1.1	2.6	1.5	0.5	4.5	4.5	3.7	4.5	6.2	4.8
1966–1973	3.3	6.4	0.2	2.9	1.5	7.0	8.8	2.9	10.9	7.9	6.0
Value-added in manufacturing											
1953–1960	5.8	10.1	2.8	6.6	4.8	10.3	13.6	8.5	n.a.	10.1	13.2
1960–1966	5.3	4.5	7.2	5.7	6.2	8.0	13.0	9.7	10.3	12.3	9.9
1966–1973	7.3	11.8	3.7	7.6	4.7	10.9	21.0	7.6	15.0	22.0	8.4
Value-added in agriculture											
1953–1960	0.5	4.0	−0.3	3.3	2.5	10.0	2.3	5.7	n.a.	3.9	3.5
1960–1966	3.2	3.8	2.7	2.7	−0.5	2.6	5.8	4.7	2.5	5.3	3.2
1966–1973	0.7	5.9	−0.7	4.7	3.0	5.6	3.2	2.4	3.1	3.8	2.0

Source: Bela A. Balassa and Associates, *Development Strategies in Semi-Industrial Economies* (Baltimore: Johns Hopkins University Press, for the World Bank, 1982), 46, 52. Reprinted with permission from the International Bank for Reconstruction and Development, the World Bank.

showed strong growth in agricultural value-added, in contrast to Argentina, Chile, and India.

In the outward-oriented countries, growth in manufactures was export driven (Table 10.3). In Korea, for example, manufactured exports rose from less than 1% of total manufactures in 1960 to more than 40% by 1973, accompanied by a rise in exports from 1.5% to more than 26% of GDP over the same period. The performance of Taiwan was almost as spectacular, rising from less than 9 to 49%. In India during this period, manufactured exports declined as a fraction of total exports while exports remained essentially unchanged as a fraction of GNP. And in this small sample, all of the inward-oriented countries showed a rise in manufactures relative to their GDP, but only Brazil and Israel showed a significant rise in their exports relative to GDP from 1960–1973, though commodity exports were at their most buoyant.

Much the same was true for Australia and South Africa. Neither increased its exports relative to its GDP, and both therefore failed to maintain their share of world exports. Though both had a substantial First World sector and several world-scale enterprises, raw or processed raw materials still constituted fully 80% of their exports in 1990. Australian performance was mediocre throughout the period, with external debt continually rising relative to GDP. Import substitution was a self-selected strategy that cut a country out of a chance to benefit from the largest growth sector in the global market, that of manufactures.

Perhaps equally revealing, the share of manufactured imports used in manufacturing declined in most countries. Inward-oriented nations were much more self-sufficient than outward-oriented ones. The consequence for local producers was less choice in terms of inputs and higher costs from sources producing small volumes for small home markets.

The impact of a strong position in natural resources and of an import substitution strategy, compared to that of a country that is focused on manufactured exports, can be suggested with a comparison of the growth trajectory for Venezuela relative to that of Taiwan. With almost no natural resources to export, Taiwan focused its energy on building manufactured products, some of which could be exported. Its development of these exports and the related capabilities needed to develop such manufactures led to a much higher growth rate through macroeconomic policies that I will explain briefly in Chap. 12. In contrast, Venezuela started the 1960s with a comparable population to that of Taiwan as well as higher incomes, but its income per capita soon fell behind as its oil income supported an exchange rate that priced its other exports out of world markets. Venezuela's import substitution strategy was financed by oil, which permitted the instant gratification of high consumption throughout these years. Taiwan, in contrast was forced to reduce its consumption relative to GDP in order to reduce its imports to maintain its balance of payments, as we will see.

All in all, one of the great weaknesses of the import substitution strategy is that it seems to be easy, almost painless. Strategies that are seemingly easy to implement are not very demanding upon government to implement, and, unless conditions are demanding, governments are not likely to rise to the occasion.

Table 10.3 The role of manufactures and trade in 11 semi-industrialized economies

	Argentina	Brazil	Chile	Colombia	India	Israel	Korea	Mexico	Singapore	Taiwan	Yugoslavia
Share of manufactured exports in manufactured output											
1960	0.8	0.4	3.0	0.7	9.7	7.9	0.9	2.6	11.2	8.6	10.8
1966	0.9	1.3	4.1	3.0	9.4	12.8	13.9	2.9	20.1	19.2	13.8
1973	3.6	4.4	2.5	7.5	8.6	14.1	40.5	4.4	42.6	49.9	16.9
Share of manufactured imports in total use of goods											
1960	14.6	10.8	26.3	30.8	19.3	28.5	24.4	19.6	56.2	28.5	22.0
1966	6.3	7.5	21.6	28.0	16.5	32.8	26.5	16.2	53.2	29.3	17.3
1973	5.4	13.0	17.5	21.5	9.5	41.2	35.9	15.2	64.3	38.9	24.0
Ratio of total exports to GNP											
1960	8.9	6.1	12.6	11.3	4.2	8.4	1.5	6.4	9.9	9.5	22.4
1966	7.3	7.1	15.7	9.5	4.2	12.8	6.5	5.4	26.6	17.1	14.2
1973	8.1	9.8	7.6	11.8	4.3	15.5	26.1	4.3	44.6	47.8	14.5
Ratio of total imports to GNP											
1960	10.3	7.1	12.9	12.6	7.5	20.1	16.0	9.0	65.4	18.9	32.8
1966	5.2	6.1	13.5	12.6	7.4	21.2	18.7	7.2	62.5	19.9	18.3
1973	5.5	11.1	6.8	10.6	4.5	30.8	34.3	8.6	91.5	40.5	22.0

Source: Bela A. Balassa and Associates, *Development Strategies in Semi-Industrial Economies* (Baltimore: Johns Hopkins University Press, for the World Bank, 1982), 46, 52. Reprinted with permission from the International Bank for Reconstruction and Development, the World Bank

Inward orientation also contributed to economic decline by putting added economic power in the hands of government officials and political leaders. These leaders were thereby empowered to undertake ambitious not to say grandiose projects which created employment, subsidized growth, and which might induce enhanced political loyalties, all at the same time. It allowed certain special interests to become winners, e.g., those with big farms or recipients of subsidies for special farming activities, as well as those with industrial and commercial activities in the cities. While typically a small minority, these winners typically had the support of the coercive powers of the state, often supplemented by other, less formal sources of force, e.g., vigilantes. However, state-controlled firms were likely to have quite different managerial habits than their private counterparts; whereas private actors would be on the lookout for new opportunities, government officials were reluctant to permit experimentation with alternative strategies that might compromise their personal privileges.

When the global credit crunch came in 1981, many countries found themselves caught with inadequate foreign exchange reserves. Retrenchment was accompanied by a slowdown in economic growth, which in Latin America has often been described as the "lost decade." For many African countries, the consequences were even worse, as they experienced an absolute decline in GDP per person. Given this poor performance among inward-oriented countries, it is small wonder that their lenders have eventually forced them toward a change in strategy.

Many observers have pointed out that average growth in per capita incomes in Latin America was much higher during the era of import substitution than it has been since. While true, this statement provides only a partial view of the truth. Many countries performed well during the 1970s with their import substitutions strategies, but often they borrowed abroad to finance these strategies so that they were, in essence, running unsustainable strategies. Lower growth recently has been accompanied by less borrowing, in a combination that is much more sustainable for the long run. The new strategy that has since then dominated is one focused on stability and efficiency and has come to be known as the Washington Consensus. While it was designed to be an escape from the prevailing notion of import substitution, it had problems of its own, as we shall see.

Chapter 11
The Washington Consensus

The ideas behind the "Washington Consensus" originated in the late 1970s at about the time that many developing countries began to ask policymakers in Washington for help in dealing with the effects of prolonged import substitution strategies: decreasing exports, crippling debt, runaway inflation, and bloated public sectors. By the mid-1980s, the policy prescriptions jelled, and in 1990 John Williamson identified a set of ten policies that "Washington" regarded as desirable. He coined the term "Washington Consensus" in a paper featured in a book of collected works on the economic situation of Latin America called *Latin American Adjustment*. By "Washington," Williamson was referring to "the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board, and the think tanks."[1] Thus, for Williamson, the term Washington Consensus was first and foremost a descriptive term. Like it or not, there was an implicit consensus in official Washington, and he had identified it and given it a name.

Obviously, there was some disagreement and debate among the various organizations as well as among their leaders, and by attributing a set of policy prescriptions to a consensus among them, Williamson was subjected to a certain amount of criticism. He was also criticized for making several omissions, a fact he readily acknowledged and justified by pointing out that there were questions about which he did not perceive any consensus. It was much later, after several countries had tried unsuccessfully to implement the consensus program, that many of these same people and organizations agreed on a much longer list of prescriptions, often referred to as the "augmented Washington Consensus."

As laid out by Williamson in 1990, the Washington Consensus prescriptions were based upon the broad theory that stabilization and liberalization would lead to increased economic stability, greater efficiency, and therefore sustained growth.

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[1] John Williamson, "What Washington Means by Policy Reform," in *Latin American Adjustment: How Much Has Happened?* ed. John Williamson (Washington, DC: Institute for International Economics, 1990), 7.

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_11,

With the exception of gaining control over expenditures and tax receipts, governments were encouraged to step back and let markets play a greater role. In effect, the Washington Consensus was largely a reflection of the precepts of neoclassical economics. Williamson viewed the program as a prerequisite for growth or a first stage of reform. In a 1994 article he wrote, "I regard it . . . as embodying the common core of wisdom embraced by all serious economists, whose implementation provides the minimum conditions that will give a developing country the chance to start down the road to the sort of prosperity enjoyed by the industrialized countries."[2]

But over time, and possibly because of difficulties with implementation, the strategy became an end rather than a means. Williamson himself recognized this in 1994, writing "Indeed, it is hard to see how all reforms could be undertaken instantaneously: while most stabilization measures can be introduced rapidly, many liberalization measures and tax reforms require detailed preparation and legislative approval, which inevitably makes for a fairly lengthy period of implementation."[3] Yet loans from international finance organizations became conditional on achievement of certain elements of the program, despite the challenges of implementing them, and sometimes they were conditional within a prescribed timetable, as was the case for Eastern Europe after Communism failed. In addition, the consensus was built upon the then fashion of deregulation, as if markets were largely self-regulating.

Elements of the Washington Consensus

Williamson's original Washington Consensus contained ten points:

1. Fiscal discipline
2. Reorientation of public expenditures
3. Tax reform
4. Financial liberalization
5. Unified and competitive exchange rates
6. Trade liberalization
7. Openness to FDI
8. Privatization
9. Deregulation
10. Secure property rights

With many economies experiencing financial crises, it was no surprise that several of the policies recommended by the Washington Consensus were aimed at stabilization. These included monetary and fiscal discipline, public expenditure priorities, tax reform, and, to some extent, property rights. Though Williamson recognized differences of opinion regarding whether or not fiscal discipline meant balancing the budget as soon as possible or a more relaxed initiative such as having a stable debt to GNP ratio, he found that Washington broadly agreed that large deficits were something to be avoided:

[2] John Williamson, "In Search of a Manual for Technopols," in *The Political Economy of Policy Reform*, ed. John Williamson (Washington, DC: Institute for International Economics, 1994), 10.
[3] Ibid., 22–23.

> [L]arge and sustained fiscal deficits are a primary source of macroeconomic dislocation in the forms of inflation, payments deficits, and capital flight. They result not from any rational calculation of expected economic benefits, but from a lack of the political courage or honesty to match public expenditures and the resources available to finance them. Unless the excess is being used to finance productive infrastructure investment, an operational budget deficit in excess of around 1 to 2 percent of GNP is *prima facie* evidence of policy failure.[4]

Prioritization of public expenditures and tax reform were the means to bring about fiscal stability. The Consensus opinion recommended reducing or eliminating indiscriminate subsidies in favor of spending on primary education, healthcare, and public infrastructure investment. He pointed out that his own view regarding subsidies was somewhat less hostile than that of the consensus. In his opinion, subsidies that could be justified in terms of improving resource allocation or income distribution were acceptable. In terms of tax reform, Williamson saw a split in the consensus between political Washington that had an aversion to tax increases and technocratic Washington that was in favor of them. However, both sides agreed that the best way to raise taxes to an "appropriate" level was with a broad tax base and moderate marginal tax rates.

Though Williamson only devoted a few sentences to property rights at the end of his list, they have become a major component in later years. Insecure property rights imply a certain measure of instability as well as increased transaction costs, and as a result they constitute a barrier to growth. Property titles must be clear if they are to serve as collateral for the mobilization of capital and to provide incentives for investment, an argument that has been more recently advanced by Hernando de Soto.

In addition to creating a stable environment, the Washington Consensus called for governments to intervene less in markets. Thus, trade and FDI should be liberalized, interest rates and exchange rates should be more or less determined by markets, state-owned enterprises should be privatized, and economies should be deregulated. In terms of trade policy, there should be access to imports of intermediate inputs at competitive prices and less protection of domestic industries. Where protection did exist it should be temporary, such as for infant industries, and provided by moderate tariffs rather than quotas. Without question, the Washington Consensus advocated the promotion of FDI to bring in capital, skills, and technology.

The Exchange Rate: Outward-Oriented or Politically Correct?

In his 1990 article, Williamson recommended competitive exchange rates and a reduction in protection of domestic industries. He noted that, according to the Consensus, exchange rate should be determined by market forces or set at an appropriate level for a target growth rate. Thus, he concluded that an appropriate real exchange rate for a developing country

[4] Williamson, "What Washington Means by Policy Reform," 10.

> needs to be sufficiently competitive to promote a rate of export growth that will allow the economy to grow at the maximum rate permitted by its supply-side potential, while keeping the current account deficit to a size that can be financed on a sustainable basis. The exchange rate should not be more competitive than that, because that would produce unnecessary inflationary pressures and also limit the resources available for domestic investment, and hence curb the growth of supply-side potential.[5]

But the World Bank had already taken the lead in creating a different and more politically correct definition of outward-oriented strategies, as a 1987 Report described:

> An outward-oriented strategy provides incentives which are neutral between production for the domestic market and exports. Because international trade is not positively discouraged, this approach is often, although somewhat misleadingly, referred to as export promotion. In truth, the essence of an outward-oriented strategy is neither discrimination in favor of exports nor bias against import substitution. By contrast, in an inward-oriented strategy trade and industrial incentives are biased in favor of domestic production and against foreign trade. This approach is often referred to as an import substitution strategy.[6]

The Report went on to characterize strongly outward-oriented regimes as those where: "Trade controls are either nonexistent or very low in the sense that any incentives to export resulting from import barriers are more or less counterbalanced by export incentives. There is little or no use of direct controls and licensing arrangements, and the effective exchange rates for importables and exportables are roughly equal."[7]

The Bank's concept of outward orientation flowed naturally from the neoclassical model that presumes markets to be in equilibrium, marginal returns across sectors to be about equal, and sectoral shifts in resources to occur gradually at the margin. In this scheme, any attempt to tilt incentives in some policy-driven direction automatically incurs economic losses; resources would be shifted from a sector with an equilibrium rate of return to one that was lower.

Most other observers followed the Bank's concept of outward orientation and, 4 years after publishing his first article on the Consensus, Williamson published another article that restated the consensus in an appendix. Interestingly, the second list was much more ambiguous. Most notably, it did not include the phrase "outward-oriented," which had been peppered throughout the first article. More importantly, his description of exchange rates in the second article was an unclear endorsement of undervaluation at best. He wrote: "Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in nontraditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future."[8]

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[5] Ibid., 14.

[6] World Bank, *World Development Report 1987: Barriers to Adjustment and Growth in the World Economy; Industrialization and Foreign Trade; World Development Indicators*, 8.

[7] Ibid., 82.

[8] Williamson, "In Search of a Manual for Technopols," 27.

In its 1987 analysis of outward versus inward strategies, the World Bank classified 41 developing economies into four categories—strongly outward-oriented, moderately outward-oriented, moderately inward-oriented, and strongly inward-oriented—and did so for each of two time periods—1963–1973 and 1973–1985.[9] Moderately outward-oriented economies were described as having an incentive structure "biased toward production for domestic rather than export markets . . . The effective exchange rate is higher for imports than for exports, but only slightly." Moderately inward-oriented economies were defined as having an incentive structure that "distinctly favors production for the domestic market . . . there is a distinct bias against exports, and the exchange rate is clearly overvalued." Strongly inward-oriented economies were described as having an incentive structure that "strongly favors production for the domestic market . . . and the exchange rate is significantly overvalued."[10]

These definitions suggest that the moderately outward-oriented category was actually moderately *inward*-oriented in an absolute sense. The evidence shows up in the performance data. For example, the inflation rate for this group during 1973–1985, shown in Fig. 11.1, was extremely high and indicative of the instability encountered by the countries following a prolonged strategy of import substitution. Included in this group for the 1973–1985 time period were Brazil, Chile, Israel, Malaysia, Thailand, Tunisia, Turkey, and Uruguay.

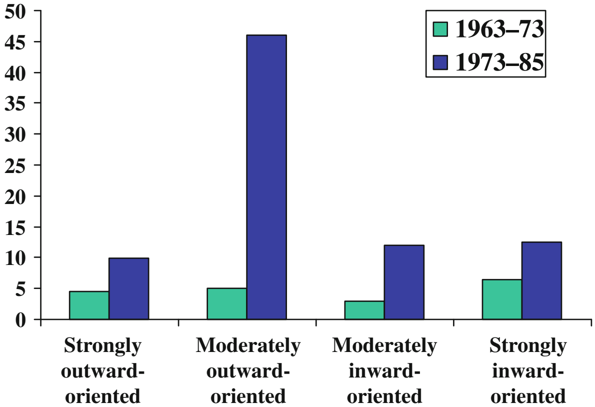

Fig. 11.1 Inflation (average annual rate). Note: Inflation rates are measured by the implicit GDP deflator. Values are group medians. Source: Adapted from World Bank, *World Development Report 1987: Barriers to Adjustment and Growth in the World Economy; Industrialization and Foreign Trade; World Development Indicators* (Oxford University Press for the World Bank, 1987), 84

[9] World Bank, *World Development Report 1987: Barriers to Adjustment and Growth in the World Economy; Industrialization and Foreign Trade; World Development Indicators*.

[10] Francis Cherunilam, *International Economics*, 5th ed. (New Delhi: Tata McGraw-Hill, 2008), 227.

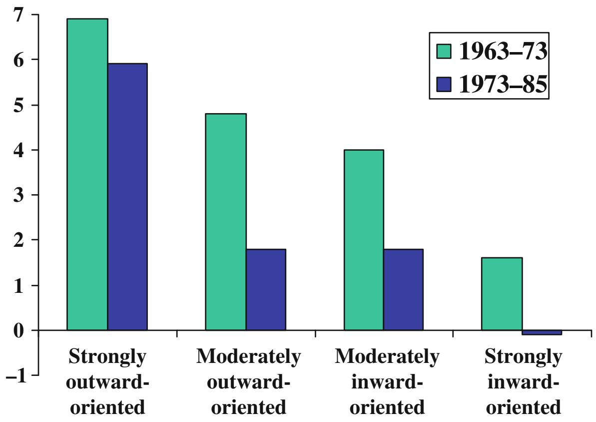

Fig. 11.2 Real GNP per capita (average annual percentage growth). Source: Adapted from *World Development Report 1987*, 84

The data for real GNP per capita also strongly suggests that "moderately outward-oriented" was a misnomer. As Fig. 11.2 shows, the performance of the moderately outward and the moderately inward economies was virtually the same—significantly better than the strongly inward-oriented, but considerably worse than the strongly outward-oriented. Also, one has to question the value of the figure for the average when the dispersion within both of the moderate categories was so wide. For example, in the moderately inward-oriented category for 1973–1985, the GNP per capita growth rates ranged from about –4% to 5.5%.

On the other hand, all of the outward-oriented economies clearly showed superior performance, but there were only three of them: Hong Kong, Korea, and Singapore. Two city-states and one nation can hardly represent a strategy in any meaningful way. China and Taiwan could have been included in this category, but were left out for political reasons.

A close examination of the 1987 World Bank study reveals the poor performance and instability of economies that followed an import substitution strategy (i.e., inward orientation) throughout the 1970s and 1980s—including those that were wrongly designated as moderately outward-oriented. The Washington Consensus was developed in response to their situation, though as we shall see below, it had major shortcomings.

Misconceptions in the Washington Consensus Model

Williamson concluded his original article by summarizing the Washington Consensus as "prudent macroeconomic policies, outward orientation, and free-market capitalism."[11] He pointed out that all of the recommendations stemmed from

[11] Williamson, "What Washington Means by Policy Reform," 18.

neoclassical mainstream economic theory and did not include any ideas from developmental theory, such as the big push, balanced or unbalanced growth, surplus labor, or the two-gap model. According to Williamson, "This raises the question as to whether Washington is correct in its implicit dismissal of the development literature as a diversion from the harsh realities of the dismal science. Or is the Washington consensus, or my interpretation of it, missing something?"[12]

Over time, Williamson's question was answered in the affirmative. But Richard E. Feinberg recognized the problem immediately:

> The Washington consensus does not encompass agreement on a theory of economic growth. Neoclassical economics is primarily an exercise in comparative statics; it lacks a robust theory of dynamic growth. The advocates of industrial policy have the elements of a growth strategy. They do not assume that markets and institutions are preexisting or that they kick in automatically once macroeconomic stabilization is achieved; rather, they recognize that markets and institutions must be created. There is no consensus on growth dynamics, although this will be more critical as the countries of Latin America move, we hope, from stabilization to recovery.[13]

Commentator Stanley Fischer picked up on the same theme:

> The big question is growth and what the government can do about it. The Washington program tells the government to do less of most things except export promotion, poverty alleviation, and the creation of an enabling environment. One of the most difficult intellectual challenges the Washington consensus faces is how to encourage private-sector development—how to create an enabling environment that is conducive to the development of an efficient private sector. The issue goes well beyond property rights to the creation of legal, accounting, and regulatory systems and the need for efficient government administration.[14]

Stanley Fischer's last comment is reminiscent of our analysis of the work of Hernando de Soto in Chap. 6. The regulatory perspective of the Consensus is that markets virtually regulate themselves, so when it comes to regulation there should be less of it. This meant that it paid virtually no attention to power differentials in society, or the need for coordination through government to mitigate bias in market frameworks introduced by wealthy oligarchs for their own benefit, or indeed challenges in offering real legal protections to people of modest means, meaning the overwhelming majorities in many developing countries. In this sense, the Consensus fails to recognize some of the systematic differences between US capitalism and its Latin American counterparts discussed in Chaps. 6 and 7. The Consensus was not sensitive to institutional differences between developed countries such as Denmark, the Netherlands, and New Zealand, for instance, and less-developed countries such

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[12]Ibid., 19–20.

[13]Richard Feinberg, "Comment," in *Latin American Adjustment: How Much Has Happened?*, ed. John Williamson (Washington, DC: Institute for International Economics, 1990), 24. At the time of his comment, Feinberg was the Executive Vice President and Director of Studies at the Overseas Development Council.

[14]Stanley Fischer, "Comment," in *Latin American Adjustment: How Much Has Happened?*, ed. John Williamson (Washington, DC: Institute for International Economics, 1990), 27–28. At the time of his comment, Fischer was a professor at MIT and Vice President of Development Economics and Chief Economist at the World Bank. He later became Deputy Director of the IMF.

as Costa Rica or Kenya. The capacity of a government to govern seemed to be beyond its frame of reference. And the notion that all countries have an implicit strategy built into the "tilt" or design of their institutions is nowhere to be found.

The fundamental flaw in the Washington Consensus model, in my view, stems from the notion that coordination to achieve economic balance is the most effective strategy for a country that there can be. This is so obvious as to be beyond discussion. The fundamental idea in the Consensus model is to promote the efficient use of resources within a given economic structure; the best way to do this is through markets, because the invisible hand is the world's best coordinating mechanism. In this perspective, economic neutrality is the best of all strategies, other things equal. The trouble is that this means accepting the existing structure as by definition best, or at least outside the framework of analysis. Here Douglass North is surely right; neoclassical economics is simply an inappropriate framework in which to conceptualize a growth model. Accelerated growth can come from more effective use of resources because they have been reallocated to sectors or niches with higher growth and/or profit potential, even if one does not necessarily use them as efficiently as in the neutral framework. Building a position in a high growth industry that lacks something in efficiency can have higher growth potential than being efficient in a low growth industry. To use a caricature, becoming efficient in making buggies or buggy whips has been a strategy for very limited growth for a very long time, no matter how efficient one becomes. It is much better to use those resources in a higher growth industry, even at less than comparable efficiency.

However, the basic problem for neoclassical economics in recognizing this reality is that the "answers" or choices of what to produce cannot necessarily be derived by a mathematical analysis of factor proportions or discounted cash flows or even contemporary rates of return. The best answers can sometimes come from situational analysis by people looking for new opportunities for existing resources, or from achieving superior human coordination of an ordinary set of resources, or extra human effort because of high morale, for instance, based upon a shared sense of purpose. These are, or used to be, elements of business administration, where management matters included human intentionality. In the atomistic and quasi-static world of neoclassical economics, where people are economic robots maximizing self-interest, such options do not exist. New options may require acceptance of short-term losses for longer-term gains, a calculus followed by many a manager. However, thinking in terms of a timed sequence of moves, as in an intentional strategy, is outside of the analytic framework. Any such framework requires the admittance of governance, or intentional change brought about by direct human agency. The science of microeconomics drives out consideration of the realities of alternative views.

The Washington Consensus implicitly assumed that the countries in trouble had sound institutional foundations, such as sophisticated legal systems and competent bureaucracies. The program also underestimated the ability of elite, entrenched interests to stymie the reform process. When these omissions became apparent, the Washington Consensus was "augmented" to an almost unending list of policy prescriptions, including legal/political reforms, regulatory reforms, reduction of corruption, labor market flexibility, financial codes and standards, "prudent" capital account opening, and social safety nets. At the same time, it had little to say on the adequacy of the public goods and services provided by the state, such as education, sanitation, highways, and law enforcement, all of which required both competence and financial capacities for government. And, instead of having single goal of growth, the consensus grew to encompass goals such as sustainable development, egalitarian development (and poverty reduction), and democratic development.[15] In essence, the augmented list recommended that developing countries try to mimic the institutions and policies of the developed countries, but without much provision for finding the managerial capabilities to do so or the financing to make them affordable.

Williamson recognized that his original list could take a considerable amount of time to accomplish and that it might challenge the administrative and political capacities of the developing countries. If that was so, what were the chances that countries could implement this longer, although desirable, list? Politics played a role in timing the implementation of economic reforms. Williamson pointed out that all political scientists agreed that it is easier for governments to introduce reforms immediately after taking power. That is because of a so-called "honeymoon period" where problems can be blamed on the previous government. Thus, the difficulty then becomes finding and maintaining support for the reforms:

> It is because of the honeymoon hypothesis that some political scientists argue that, from a political standpoint, the most difficult part of a reform program is not introducing the reforms but sustaining them until they have a chance to bear fruit and thus generate political support from the potential beneficiaries. How difficult this will be depends upon the lag between the initial reforms and the emergence of politically significant beneficiaries—a topic on which most economists would probably be far more cautious now than a decade ago. It has even been suggested that programs should be designed to try and ensure the early emergence of some such group of beneficiaries, but the question arises as to whether such manipulation is compatible with the basic philosophy of economic reform, which is to provide a level playing field rather than favor particular groups.[16]

The Role of Developmental Strategy

While the augmented Washington Consensus implies a great deal more government involvement than the original version, it does not advocate nearly as much as the strategies used by the most recent success stories. Stanley Fischer called attention to key differences between the Washington Consensus and the more interventionist East Asian strategy:

> Growth will not return to stagnating countries until investment increases. Certainly getting the macro environment right is a necessary prerequisite. Beyond that, there are two possible

[15] Joseph Stiglitz, "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus" (The 1998 WIDER Annual Lecture, Helsinki, Finland, January 7, 1998).

[16] Williamson, "In Search of a Manual for Technopols," 20–21.

> approaches. One, the Chilean or Thatcher approach, requires the government to set the right policies and incentives, to behave consistently and credibly, and then to step out of the way in the expectation that, eventually, growth will return. This approach seems to work, eventually, at least in those countries that have the institutional capacity to support it. . . . The alternative, East Asian approach is one in which the government takes a more active and ongoing role, in some interpretations operating an industrial policy. The East Asian experience proves that small government, consistent policies, an undervalued currency, export promotion and explicitly time-limited import protection through tariffs, and an educated and disciplined labor force, combined with entrepreneurial skills, create economic growth.[17]

Dani Rodrik summarized the strategies of successful strategies in the post-World War II era:

> The Chinese experience represents not the exception, but the rule: transitions to high growth are typically sparked by a relatively narrow range of reforms that mix orthodoxy with domestic institutional innovations, and not by comprehensive transformations that mimic best-practice institutions from the West. South Korea and Taiwan since the early 1960s, Mauritius since the early 1970s, India since the early 1980s, and Chile since the mid-1980s are some of the more significant examples of this strategy.[18]

The Challenge of Economic Inequality

One view of economic development is that all countries are more or less the same, only some are richer and therefore more developed than others. Another is that all countries have distinctive institutions that are rooted in their past histories. Some of these institutions might have been very beneficial at an earlier point in time but might, in the meantime, have become dysfunctional. The view of this section—and, indeed, of this book—is that the institutional differences between rich countries and poor are far greater than is implied simply by differences in their respective incomes or wealth per person. The comparison between the US experience and Latin America in Chaps. 6 and 7 illustrates these differences. Despite its head start in development, Latin America fell behind North America in the development of its institutions of capitalism, and it was this lag in development of capitalist capabilities—and not simply the notions of deregulation and market neutrality—that was the key to growth.

The developed countries have built their capitalist institutions through painstaking reforms, coupled with trial and error as well as copying successful experiments in other countries, as explained for the US case in Chap. 7. As a result, the industrial countries have more developed institutions and, in a sense, much less need for reform than their less-developed competitors; they could probably coast for a few decades and still be far ahead in this respect. Instead of coasting, however, all have

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[17] Fischer, “Comment,” 28.

[18] Dani Rodrik, “Feasible Globalizations” (Harvard University, July 2002), 8–9, http://www.hks.harvard.edu/fs/drodrik/Feasglob.pdf.

functioning democracies that have the capability to legislate more or less appropriate reforms in a more or less timely fashion.

The developed countries have this institutional advantage not only because they had a head start of several centuries in developing their capitalist systems, but, as in the US case where they started with a considerable lag, because they have gradually achieved the capacity to continuously modernize their institutions in a timely way. Implicitly, this means that the developed countries have a comparative advantage in terms of effective institutions of government. This modernization might include developing the capability to import new technologies, to domesticate them, and then to diffuse them within the local market.

A relatively egalitarian distribution of wealth is a positive component element of the egalitarian model, as outlined in Chap. 4. While their wealth distribution may not be as egalitarian as in the model, it is characterized by a strong middle class and is somehow blessed with political institutions that allow it to govern more or less in the interests of the middle class. On the other hand, most developing countries are trying to catch up institutionally while trying to get legislation through a parliament whose electorate comes from one version or another of the oligarchic model. For want of a strong middle class, the legislative problems are much more difficult, not least because powerful vested interests try to block reforms that are to their disadvantage. Indeed, they are often prepared to corrupt the system if necessary to stymie such reforms, as they did in the US South prior to the 1960s and continue to do in the Mezzogiorno.

Consider the data on inequalities shown in Fig. 11.3. Was it appropriate to have the same generic strategy for countries as different in their social structures as Brazil and Venezuela on one hand, and India and Indonesia on the other? Surely even this is too crude a comparison, because India itself has several states, such as Bihar and Andhra Pradesh, where the inequalities would resemble those in Latin America. These states, as well as others in Indonesia and Nepal, have been plagued by low-level violence for decades, as near-feudal landlords try to preserve their privileges while leftist guerillas try to overthrow them, in patterns that resemble those in Guatemala, El Salvador, Honduras, and Nicaragua. Reform is surely more difficult in oligarchic societies, even when a previously egalitarian society drifts into the oligarchic mode, as we will see in the US case in Chaps. 13 and 14. The notion of systematic distortions due to oligarchy seems completely missing, as indeed they were in the context of Britain and the United States as they were formulating their notions of radical deregulation in the 1980s.

If there were to be a demarcation line between the egalitarian societies and those that were oligarchic, where would that line be drawn? If one were to choose an arbitrary boundary as applicable to Fig. 11.3, it might be at the twenty to one line. This would put all of the developed countries in one group and all of Latin America, exclusive of Uruguay, in the other. Of course the first group would also include Iran, along with India, Indonesia, Egypt, and Russia. But states or provinces in these latter countries would surely look more like the second group. This would seem to suggest that demarcation lines based upon measures of income distribution are very crude, and probably too crude to be of much value for policy guidance. It may be that what

Fig. 11.3 Income levels and income distribution for select countries. Sources: GNI per capita is provided in ($PPP) for 2004, as found in *The World Development Report 2006: Equity and Development* (The World Bank and Oxford University Press, 2005), Table 1, pp. 292–293. Data on equality (Richest 10% / Poorest 10%) were found in *Human Development Report 2005: International cooperation at a crossroads* (New York: United Nations Development Programme, 2005), Table 15, pp. 270–273. GNI data come from 2004; whereas equality data, from the UN, are culled from surveys conducted between 1990 and 2002

we need is a way to compare the size and power of large firms and their associated industry associations with the power of the state in particular countries. Our simple typology for states as egalitarian, oligarchic, and authoritarian may well have more analytic utility than the more formal classifications based upon the distribution of income. Perhaps the real governance problems in developing countries are more closely related to the relative powers of firms than to those of individuals. I consider this possibility in Chap. 13, where the largest US firms became far larger than most state governments in a set of circumstances that undermined democracy in many areas.

Reform in an Era of Globalization

Perhaps we should be guided in our classification of countries or states within them, by the questions that we are trying to address. One such question is the assumed degree of stability of the country or state; stability is especially important in a democracy, where government can be overthrown in some circumstances. The diagrams would suggest that the oligarchic societies have a much more unequal distribution of political power, whatever its source might be, and this might be a better guide to the prospects for societal conflict. As in the historically segregated Old South in the United States, the social hierarchy of oligarchy would likely be based upon political power far more than economic. A racist sheriff backed by a white jury could intimidate blacks to forego their voting rights and, thus, their job and educational opportunities. Middle-income people could and did oppress those who were poor, by burning crosses or houses or, in the extreme, by organizing lynchings. It is the distribution of political power that matters most, not the Gini coefficient.

The Washington Consensus implies the need for greatly increased public goods and services in developing countries. Any such public monies need to be spent wisely, and this cannot be assured in states where the electorate is not well educated and/or where the political institutions tilt power in the direction of a rich elite. This poses an additional set of questions: How would any additional public goods or services be financed? Should they be financed by indirect taxes on trade, by value-added or excises on luxuries, or instead by direct taxes on incomes or property? The characteristic means of financing government expenditure in Latin America was quite striking compared to that in developed countries, as shown in Table 11.1. As shown in Table 11.1, Latin American middle classes pay a disproportionate share of the taxes compared to their counterparts in rich countries, because the rich in Latin America pay very little either in personal income taxes or real-estate taxes. This kind of tax incidence sets a lower lid on the total revenues that can be raised, because high taxes will affect the consumption of the poor and threaten political stability. Continued under-provision of public goods is a convenient short-term fix, but it implies very serious long-term costs. Poorly educated people will have less and less value in a global market place.

Table 11.1 Tax structure in the 1990s, Latin America and developed countries[a]

Tax category	Latin America and Caribbean 1995–1999	Developed countries 1991–2000
Income taxes	3.4	9.7
Individual	0.9	7.1
Corporate	1.7	2.3
Social Security	2.9	7.8
Taxes on goods & services	7.4	9.5
Trade taxes	1.8	0.3
Property taxes	0.3	0.8
All taxes	16.1	28.7

[a]In percent of GDP, central government.

Source: *Inequality in Latin America and The Caribbean: Breaking with History?* eds. David de Ferranti, Guillermo E. Perry, Francisco H. G. Ferreira, and Michael Walton (Washington, DC: World Bank, 2004), 252. Reproduced with permission of World Bank.

Thus far, our examination of inequality and its relationship to policy priorities has been in a static context; what happens if we consider inequality through time? Market liberalization, through the opening of borders and deregulation of the home market, promotes market integration, and market integration can be expected to have three major effects: (1) increasing productivity and rising living standards; (2) increasing inequality; and (3) decreasing stability in terms of employment. The connection between increasing market liberalization and increasing inequality is apparent in the relative incomes enjoyed by the top 10% of earners in three leading examples of deregulation: New Zealand, the United Kingdom, and the United States, as shown in Fig. 11.4. D9 represents the 90th percentile and up, while D1 represents the bottom 10% of incomes. As shown in the figure, the top 10% diverges from the bottom 10% in the 1980s, the period when the reforms associated with Roger Douglas, Margaret Thatcher, and Ronald Reagan were implemented in New Zealand, the United Kingdom, and the United States, respectively.

While this may or may not have been a good thing, it was not inevitable, as can been seen below in considering what happened in three other high income countries that did not liberalize their labor markets in similar fashion. In Fig. 11.5, Japan and France show a slight increase in inequality or income divergence, while Germany shows the reverse; its lowest decile had more rapid income growth than either the middle decile or the highest. This second group of countries is sometimes noted for

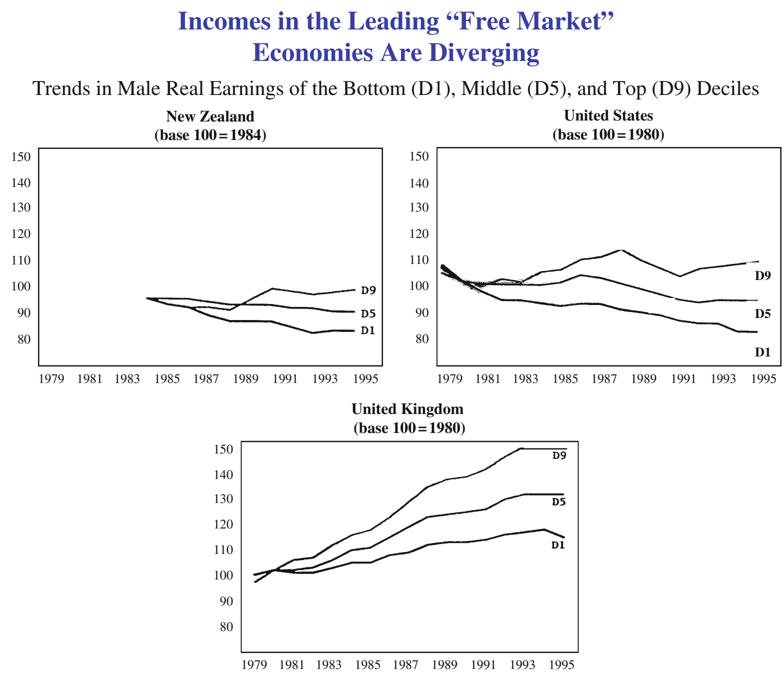

Fig. 11.4 Incomes in the leading "Free Market" economies are diverging. Source: "World Employment 1996/97: National policies in a global context" by the International Labour Office

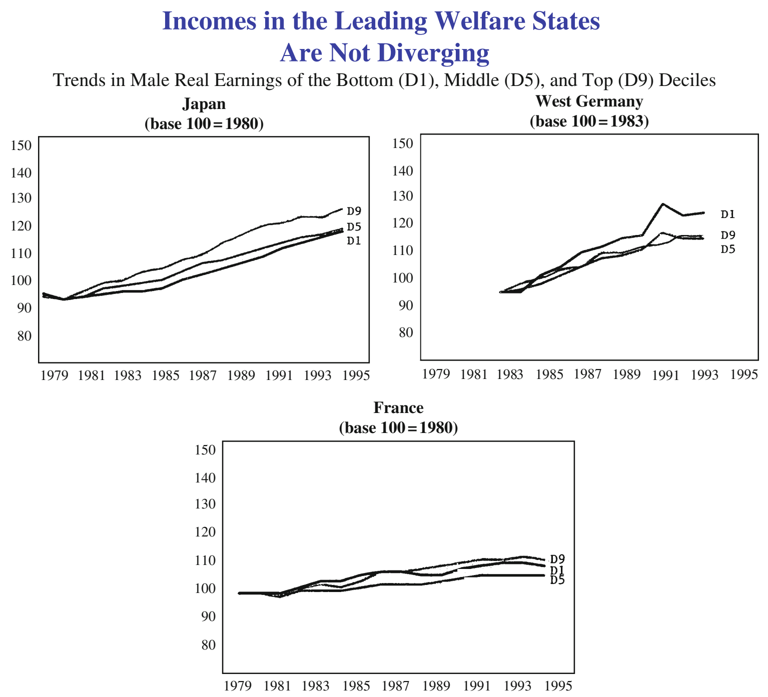

Fig. 11.5 Incomes in the leading welfare states are not diverging. Source: "World Employment 1996/97: National policies in a global context" by the International Labour Office

having coordinated market economies (CME's), as opposed to the liberal market economies (LMEs) of the English-speaking countries.[19] In this perspective, the Scandinavian countries would be part of the CME group, as would Belgium and the Netherlands, while Australia and Canada would belong to the former group.

The data in Figs. 11.4 and 11.5 reflects relatively short-term trends following well-known market-oriented reforms. They are also consistent with underlying data, as shown earlier in Fig. 11.3. Thus, if one takes an un-weighted average of the consumption of the top decile in the five English-speaking countries, it is about 15 times that of their lowest decile, while the un-weighted average for the coordinated market economies including Sweden and the Netherlands is about five times. In general, the countries of Western Europe other than the United Kingdom have pursued a variety of policies designed to sharply limit their inequalities of income and wealth, and have maintained that stance even while the British have allowed their inequalities to grow. Whether the inequalities that exist within the English-speaking countries are high enough to be considered oligarchic would seem to be largely in the eye of the beholder. We will consider this issue again in Chap. 14 in a 21st-century context.

[19] See, for example, Hall and Soskice, *Varieties of Capitalism*.

One could amplify the inequalities by switching from the top 10% to the top 1%. In this latter perspective, "the share of aggregate income going to the highest-earning 1% of Americans has doubled from 8% in 1980 to over 16% in 2004. That going to the top tenth of 1% has tripled from 2% in 1980 to 7% today. And that going to the top one-hundredth of 1%—14,000 taxpayers at the very top of the income ladder has quadrupled from 0.65% in 1980 to 2.87% today."[20] Was any of this a problem? *The Economist* magazine had not one opinion on this, but two:

> To many who would discredit American capitalism . . . any system in which the spoils are distributed so unevenly is morally wrong. This newspaper disagrees. Inequality is not inherently wrong—so long as three conditions are met; first, society as a whole is getting richer; second there is a safety net for the very poor; and third, everybody, regardless of class, race, creed or sex has an opportunity to climb through the system. A dynamic economy may sometimes look ugly, but it offers far more hope than a stagnant one for everybody in the United States.[21]

Three years earlier, in its special 150th anniversary edition, *The Economist* had taken quite a different stance, stating:

> [T]he main dangers to the success of capitalism are the very people who would consider themselves its most ardent advocates; the bosses of the companies, the owners of companies, and the politicians who tirelessly insist that they are pro-business . . . At the heart of capitalism's troubles lies executive pay . . . there has been no link between pay and performance. The really damaging perception now is that many of these mega incomes have been gained through the abuse of power—and that, in some cases, they are also being preserved by the use of that moneyed power in politics. Worse still, that perception is largely correct.[22]

In its earlier look at inequality in the United States, *The Economist* had used two different criteria for citing high executive pay as a threat to the system: first, it was not based on merit and, second, it could be based upon the use of political power to corrupt the system.[23] What if the high levels of pay reflected forms of monopoly rents for critical skills, as in bond trading; an abuse of power, such as in self-dealing in recommending executive salaries; or, worse still, corruption of the system through lobbying for special advantages to boost profits, such as reduced taxes or regulations? If there were very high incomes, was there any way to make sure that they were legitimate? Who would decide?

Further questions follow. If *The Economist's* support for high pay in a global economy applies in the case of the United States, does it also apply in the case of the Latin American countries? Is increased inequality acceptable in Latin America, for instance, in Brazil or Venezuela, where the top 10% earn 60 or 70 times what the bottom 10% earn, instead of only the 15 times in the United States? What if these countries also have rising incomes, a minimal safety net for the poor, and no

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[20] "Inequality in America," *The Economist*, June 15, 2006.

[21] Ibid.

[22] "Capitalism and Democracy," *The Economist*, June 28, 2003.

[23] Ibid.

overt discrimination by race, creed, or sex? Are high executive salaries merited, or perhaps the result of cronyism or outright corruption? Should they be prima facie grounds for suspicion?

Conclusions

The Washington Consensus strategy was developed as a response to the distortions created by strategies of prolonged import substitution, i.e., those countries that had reached Phase II. It was common for such countries to have budget deficits to support aggressive public spending and, in addition, to have inflation, an overvalued exchange rate, and a tendency to resort to foreign borrowing to support that unrealistic exchange rate. Given the gross levels of mismanagement that were often encountered in such cases, as suggested by the data in Fig. 11.1, and particularly the average inflation data for the moderately inward-oriented countries that had been mislabeled moderately outward-oriented, the Washington Consensus was certainly an understandable response, at least as a corrective measure for years of mismanagement. However, it was sold as a long-term, one-size-fits-all remedy that could serve as a template indefinitely. That was surely claiming far too much.

One of the greatest strengths of the Washington Consensus strategy has been that, because of its focus on market neutrality and fiscal rigor, it is one of the least demanding strategies in terms of economic and technical competence required of government. Liberalization and privatization imply a sharp decrease in the role of government, as does a retreat from Keynesian notions of managing aggregate demand in an open economy. Given the accumulated distortions caused by years of import substitution regimes, countries that adopted the strategy probably made a step in the right direction.

Yet the "model" recommended by Washington in the 1980s and 1990s is not one that thus far can claim many successes among developing countries. In the conceptual scheme used in this book, the Washington Consensus recommendations comprise a strategy of economic neutrality in the product and factor markets. While this strategy may have been an improvement from the situation in which inward-oriented countries found themselves during the 1980s, especially in terms of avoidance of excessive government borrowing and balance of payments difficulties, there is no compelling evidence that an essentially laissez-faire model is the route to eventual catch-up. Joseph Stiglitz characterized it in much the same vein as Stanley Fischer:

> The goal of the Washington Consensus was to provide a formula for creating a vibrant private sector and stimulating economic growth. In retrospect the policy recommendations were highly risk-averse—they were based on the desire to avoid the worst disasters. Although the Washington Consensus provided some of the foundations for well-functioning markets, it was incomplete and sometimes even misleading.[24]

[24] Stiglitz, "More Instruments and Broader Goals."

Developing countries have good reason to be reluctant to abandon inward orientation in favor of an economically neutral—let alone outward/producer-oriented—strategy. Since most of these countries have very unequal incomes, a history of ineffective government, and few prospects of growing rapidly, the average voter would have to agree to short-term sacrifices, such as a currency devaluation, a reduction in real wages, budget austerity to achieve macro stability, or a reduction in real incomes for a "vision" of shared future gains. It is not hard to see why countries have stuck with the devil they know. Second best may be far better than botching an attempt at first best.

In fact, the Washington Consensus is essentially the model adopted by the rich countries long after they had achieved sustained growth. Before they got rich, some of them had used inward-oriented strategies and others the outward strategy, as we will see in the next chapter. The Washington Consensus model has not been a well-trodden route to wealth, but rather a strategy adopted by those who are close to the technological and organizational frontiers. More recent success stories in East Asia were also the result of outward-oriented strategies. But just as the World Bank defined the extremely outward-oriented as neutral, several observers described East Asian policies as "free market" until they hit the 1997 crisis, at which point they were criticized for their interventionism or "crony capitalism." All too often the labeling was dictated by the performance instead of the policy and institutional design. There was a great deal at stake in the labeling: organized economics had a considerable vested interest in calling successes free market and neutral, whether they were or not.

While the Washington Consensus strategy was surely a great improvement over many versions of excessively ambitious import substitution, and particularly its Phase II versions, it was hardly a robust strategy with much promise of permitting developing countries to converge toward rich countries in terms of income levels. Latin Americans were particularly distressed when, roughly 20 years after their transitions to the Consensus, their growth rates were still about half what they had been under their previous import substitution regimes. Their economies were more stable, and perhaps more efficient, but not more just or equitable. And they continued to disappoint in terms of growth.

More robust growth and greater equity imply the need for more public goods, notably more and better public education to develop human capital and more effective law enforcement to protect people of moderate means. Schools, police, and courts, not to mention roads and sewers and fresh water, all require more government and more spending, not less. This puts developing countries in a double bind. They typically have weak not to say corrupt officials, both elected and appointed, and so are ill-equipped to assume added responsibilities. In addition, their wealthy citizens typically resist paying much in direct taxes (i.e., taxes on incomes or property). Therefore the increased public goods have to be paid for in disproportionate measure by the poor, and thus the strategy becomes perceived as unjust and invites instability.

This seems naïve on the face of things. The Washington Consensus lacks any recognition of the inevitably antagonistic side of the relationship between capitalism and democracy. Since many, though by no means all, of the developing countries are democracies, the failure to articulate a way to constrain the already high, and often rising, inequality that can be expected with continuing globalization is sure to remain a considerable shortcoming for the foreseeable future. That these inequalities may motivate still more corruption through special interests seeking favors from government is surely a possibility. In this sense then, one could say, as *The Economist* did in its anniversary issue, that capitalist greed has been the greatest threat to the long-term future of capitalism. The Washington Consensus has yet to take this issue into account, let alone suggest ways to mitigate such possibilities in countries already burdened with oligarchic economic and political power structures. In this sense, neoclassical economics avoids recognition of some of the political consequences and/or imperatives of development. It is simply a very incomplete model of an economy, and especially of one that has the imperfect institutions so characteristic of developing countries.

Chapter 12
Neo-Mercantilist or Enhanced Mobilization Strategies

In this chapter I examine what I call "enhanced mobilization" (EM) strategies for economic development. While this strategy has been relatively rarely practiced in the last century, in my view it has been the highest-performing strategy in terms of permitting a country to catch up with other countries that are more advanced. I use the term enhanced mobilization instead of two other names that may be more familiar, i.e., "export promotion" and "neo-mercantilism." I prefer not to use these latter terms because the first term fails to fully capture the overall idea, and the second term carries some historic baggage that could be a distraction.

As we will see, strategies of enhanced mobilization can take a number of forms, some more comprehensive and ambitious than others. However, I begin with a word of caution about the full applicability of this model in a contemporary context. All of the full-fledged examples of the enhanced mobilization or EM model that I have encountered have been created in a context of clear and present external threat or challenge to the state or nation involved, and a number of the societies that have fully embraced this strategy have been characterized by strong and even illiberal and/or undemocratic governments at the time that it was adopted. Since illiberal and less than democratic governments are not generally considered models for other societies to follow in our contemporary context, I have chosen to give disproportionate attention to examples from liberal democracies, even if that means using a number of cases where the strategy has been applied only in part. It is the ideas that are my target.

The enhanced mobilization strategy starts from five core premises: (1) private initiatives coordinated through markets, if left to themselves, will not necessarily generate either the diverse opportunities or the more demanding mobilization of resources necessary for an accelerated process of modernization that is, in turn, needed for the rapid growth and development of a country catching up with others; (2) modernization is typically driven by rapid industrialization, which, in turn, induces urbanization and rising levels of education. Rapid industrialization demands a high level of resource mobilization in terms of education, saving, and investment so as to develop human as well as financial resources; (3) high rates of investment can be triggered by policy-based changes to market frameworks that increase the risk-adjusted returns available to investors, particularly in new activities, while also permitting unusual leverage to some producers under certain conditions; (4) the best

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_12,

way to increase investor returns is through interventions to reduce factor costs in the economy; (5) to sustain a high rate of growth typically requires a very high rate of saving as essential to reducing the rising imports of consumer goods that would normally accompany the high growth.

The idea of EM transcends the concept of government intervention to remedy traditional market failures. In this perspective, development is seen both as a dynamic process of nurturing additional economic opportunities through diversification based on the mastery of new technologies and new ideas and as an accelerated transfer of resources to these new areas of investment and growth. Enhanced mobilization is animated by the goal of achieving a better society and not just pursuing existing comparative advantages. Since the vast majority of civilian research is tied to the manufacturing sector, manufactures are promoted as a priority, and higher technology manufactures are promoted as the process proceeds. This strategy tends to suppress consumption as a share of GDP, but it expands individual welfare by the more rapid creation of higher skill and higher productivity jobs. Adam Smith famously suggested that the only purpose of production was consumption; this strategy implies otherwise, using productive activities to give a structure to society and inducing diversification of opportunities to learn, whether in a research-setting or in a management-setting within an existing enterprise. It follows more the line of thinking of Alexander Hamilton, who recognized that the processes of product development and production give a structure to life that can enhance its human value beyond that of trading, as well as supply the means to pay for additional consumption.

Enhanced mobilization can be contrasted with the Washington Consensus approach to economic development, where countries aim to phase out restrictions on trade and investment flows, maintain anti-inflationary monetary policies, eliminate structural budget deficits, and minimize distortions in the local economy. By successfully implementing these measures, the Washington Consensus countries should achieve economic efficiency and stability, two key conditions favorable for growth. In addition, these measures should allow developing countries to align their internal prices with those in world markets, thereby permitting them to achieve inflows of foreign capital as well as what is sometimes termed “export-led growth.” Stability and efficiency are desirable goals and are less risky than attempting an enhanced mobilization of resources, but they do not have particularly favorable upside growth prospects, as Richard Feinberg and Stanley Fischer pointed out in the previous chapter.

While enhanced mobilization (EM) strategies are also premised upon economic stability, they differ from the Washington Consensus in terms of all five of the key ideas. Whereas the Washington Consensus model assumes that private actors will search out and develop all appropriate opportunities at an appropriate time through decentralized decision-making in markets, the EM model posits that inertia plus perceived risks may deter timely investments in new technologies and/or relatively large-scale investments. Coordinated action by government may help launch a new activity, which, once underway, can be taken further by market-based private initiative. The EM model posits that enhanced levels of resource availability depend primarily upon the mobilization of domestic resources, notably on domestic savings, and typically at the expense of short-term consumption. While the Washington Consensus aims for market neutrality as achieved by mutual bargaining by autonomous economic agents, thereby "getting the prices right" and minimizing economic rents, the EM model is based upon a policy-driven "tilt" in some market frameworks to favor producers relative to consumers, i.e., sometimes deliberately "getting the prices wrong" from the point of view of short-term consumer welfare.[1] It achieves this tilt by intervening to increase the returns to (and reduce the risks of) targeted investments through the deliberate creation of economic rents so as to induce firms to change their behavior. In addition, it induces this rent creation in a context where these policy-induced rents will be captured largely if not entirely by domestic producers.

Unlike Import Substitution, which aims to create rents by protecting domestic markets and thus allowing domestic prices to rise to above world market levels, the EM strategy aims to create economic rents through reducing factor costs in land, labor, and/or capital below market clearing levels. With lower costs, the manufactures can also be exported, which opens additional opportunities for increased specialization through increasing participation in world markets. Where the Washington Consensus strategy aims to intervene in markets only to correct so-called market failures in a static, allocative sense, the EM strategy aims to alter the design of the market frameworks to deliberately create a market tilt or distortion that induces higher rates of saving, investment, and growth, albeit sometimes at higher risk. For example, while the Washington Consensus framework aims for consumer benefits in the short term, the EM strategy aims to tilt the market frameworks to boost risk-taking and investment today to provide for a richer, more diverse set of activities tomorrow. This richer set of activities should, in turn, help mobilize additional entrepreneurial energy and capital to generate higher productivity and higher incomes in the future. The underlying rationale for this strategy is that citizens are producers as well as consumers, and more diversified work opportunities, including in higher technology sectors, provide additional opportunities for human development through more interesting and challenging careers, albeit at some short-term sacrifice in the consumer standard of living.

Enhanced mobilization strategies are distinct from the "strategies for rapid accumulation" identified by the World Bank in its special report analyzing the East Asian Miracle.[2] While there are many points of agreement between the two, the differences begin with the notion that accumulation is a passive concept, while mobilization is an active one. The Bank explained that rapid accumulation was due mostly to getting the basics right, while conceding that at least the active interventions had not been unduly harmful, as indicated by the superior performance

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[1] Alice H. Amsden, *The Rise of "The Rest": Challenges to the West from Late-Industrializing Economies* (New York: Oxford University Press, 2003).

[2] The World Bank, *The East Asian Miracle: Economic Growth and Public Policy*, World Bank Policy Research Reports, 1993.

of the countries selected. However, the EM model is premised on the notion that certain interventions are fundamental to achievement of enhanced levels of mobilization, particularly of savings and credit expansion, and especially to achieving the economic rents that are designed to induce the accelerated diversification of the economy into areas of increasingly attractive opportunity, in spite of the fact that these may not be areas of existing or near term comparative advantage. Perhaps the most fundamental differences stem from the Bank's stated goal of reliance upon efficient markets characterized by minimal distortions for maximizing short-term consumer welfare as fundamental to their model. The EM model relies upon policy-based distortions to increase the risk-adjusted rate of return on certain classes of investments as a market-based strategy for mobilizing added investment in these areas. It also accepts added risk-taking, such as added financial leverage, in order to facilitate added investment. The market distortions embodied in this strategy deliberately force workers and/or consumers to subsidize producers and/or accept higher risks in the short run in order to achieve a more dynamic economy. Later in this chapter, I will revisit the policy and institutional choices for the Bank's rapid accumulation strategy and compare them with the somewhat longer as well as different list of key policies and institutions for enhanced resource mobilization.

Enhanced mobilization strategies pose a number of challenges for decision-makers; they are clearly much more difficult to implement effectively than the Washington Consensus model and quite likely beyond the established capabilities of many governments. Enhanced mobilization is difficult to sustain in either a liberal or democratic context, and it should be seen as a transitional or catch-up strategy and not as a "permanent" alternative to decentralized decision-making through markets. At the same time, it should be noted that this strategy has been used for periods of 30 or more years in Japan, Korea, Singapore, and Taiwan, beginning in Japan in the 1950s. Moreover, it has been subsequently been applied in Malaysia and China. And in each case it has yielded considerable success.

The challenges to successful articulation and implementation of such a strategy fall into three broad categories: meeting a set of social and institutional preconditions for political, technical, and administrative viability; articulating the basic ideas as applicable to the country in question; and implementing the supporting measures. I consider these steps in turn.

Essential Preconditions

Economic policy does not take place in a social, political, or institutional vacuum. As we have seen in a number of examples, including in Italy as well as the United States, well-meaning interventions can fail even in developed countries, if underlying institutions are dysfunctional or entrenched elites work against them. This is particularly the case with EM strategies, which require more ambitious interventions than either import substitution or the Washington Consensus formulae, and therefore the necessary preconditions are far more demanding. There are at least five such preconditions.

A Clear and Present External Threat or Nation-Building Challenge

I suggest that the only countries likely to successfully adopt EM strategies are those faced by a "clear and present" external challenge, if not danger. When properly framed, this challenge can justify a degree of resource mobilization and allocation reminiscent of wartime, hence the notion that the strategy is neo-mercantilist. In some of the cases of EM, the drive to achieve accelerated development was in fact motivated by the need to be able to finance enhanced military forces (as, for example, in China, Korea, Singapore, and Taiwan). In these and other cases, a desire to achieve economic parity with developed countries was an essential aspect of political equality (e.g., Malaysia). For Japan in the period 1950–1985, much of the motivation was to show that its economy could be rebuilt from its wartime losses in a way that would establish something like economic parity with the victorious powers. Stated a bit differently, the Japanese sought an economic strategy to achieve the economic and political power that their military strategy had failed to achieve.

The EM strategy has often been called neo-mercantilist, and with considerable justification. But it need not be related to the projection of military power, as the original mercantilist strategies often were. Elements of the EM strategy have been successfully adopted by established industrial democracies trying to stem emigration or unemployment, as we will see.

An Absence of Great Natural Wealth (or the Necessity to Sacrifice)

I suggest this as a precondition not because resource wealth is an inherent liability, but because its existence makes it extremely difficult to motivate political leaders to undertake added mobilization of resources. Typically, countries that adopted the EM strategy had no easy alternative, such as oil or coffee exports, that would allow them to meet their goals. In resource-rich economies, elites have often been unable to resist rent-seeking activities, rigging politics and markets to maximize their economic rents, and creating elaborate patronage regimes to entrench their position. Corruption impedes the development of the political will, let alone the technical and administrative skills to aim for anything other than the short-term gains of those in or near power. Political leaders and government officials must share a sense of purpose that transcends raising the consumer standard of living, if such a strategy is to be implemented; easy access to wealth blunts any such sense of sacrificing for a collective purpose.

Assurance That the Benefits of EM Will Be Broadly Shared Over Time

Promises of cake tomorrow are not equal to cake today, especially not if the leader making the promise has frosting on his fingers. Results are a way to merit support. There are several ways to assure the public that the gains from enhanced mobilization will be broadly shared. Just as I have only found EM strategies where there has been a clear challenge or threat to the sovereignty or welfare of the state, I have also only found it where there is a broadly egalitarian distribution of income and/or wealth. In a lesser emergency, a partial strategy of EM can be achieved through a social contract that implies reciprocal obligations for the key economic actors, and usually for organized labor and management. The sense of broadly shared benefits can be greatly enhanced if the state already provides high-quality public goods and services in adequate quantities. Good public education is a must, as it is essential for those who aim for upward mobility to take advantage of new opportunities. But there should also be broad-based access to public health infrastructure (e.g., clean water and sewers) and broad-based legal protection for persons and property.

A Strong, Competent, and Legitimate State, Committed to "Enlightenment Values"

A strong, legitimate state will be better able to resist the influence of economic elites and other rent-seekers. More than a minimal level of competence is required for the state to meet the demanding policy requirements of EM strategy. By "commitment to enlightenment values," I mean a government that is willing to apply reason and science to advance the welfare of its people and that rejects fundamentalist rhetoric, whether religious or secular in origin. Whereas it is theoretically possible for any country to accept the principles associated with the Enlightenment, it is unlikely to occur unless there has been a clear separation of church and state.

Articulating the Strategy for the Country Context in Question

The primary interventions in EM strategies include: (1) the creation and/or modernization of a set of policies and institutions designed to enhance the diversification of the economy, not in a random manner, but in a purposeful manner that aims to move its technological and human skill base upward toward industries and eventually services with relatively high growth and/or value added per employee and per dollar of capital invested; (2) a set of mostly market-based measures designed to increase the rate of saving as a share of GDP, to reduce consumption as a share of GDP, and to reduce consumer goods as a share of imports; (3) elaboration and implementation of a set of producer-oriented policies and institutions that permit additional risk while raising risk-adjusted returns in a variety of industries, especially in those with significant export potential; (4) expansion of domestic credit to finance an increased rate of investment, while at the same time permitting firms to have higher than normal rates of financial leverage; and (5) maintenance of an undervalued exchange rate as a broad measure supporting points 2 and 3 above. Since high growth will almost certainly induce rapid import growth, trade and current account deficits typically set a boundary condition on how fast an economy can grow with this strategy. Measures

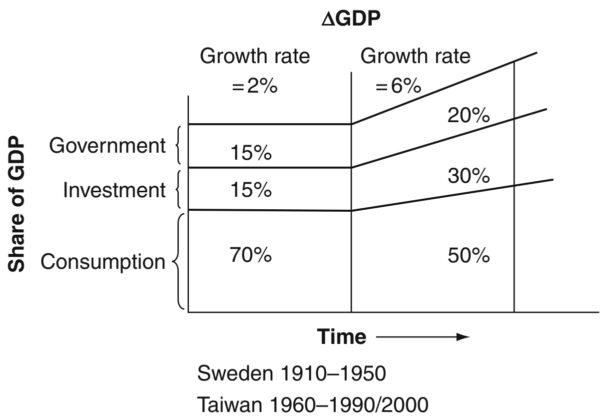

Fig. 12.1 With the enhanced resource mobilization strategy, consumption falls as a share of GDP but rises in absolute terms (country illustrations of approximate saving and growth dynamics). Source: Bruce R. Scott

to reduce consumption as a share of GDP or GDE (and thus of imports as well) are therefore vital, as indicated by Fig. 12.1.

The articulation and periodic modernization of any such array of interventions requires acceptance of the idea that government should have the technical capability as well as the political power to intervene to reshape market frameworks. In the first category, one can cite the establishment of research institutes or consortia that have the backing of state subsidies, and perhaps the use of state resources to acquire key technologies abroad. State-owned and/or state-regulated financial institutions typically play a key role in domestic credit expansion.

In the second category, governments can intervene to reduce capital costs through controlled interest rates on deposits and loans, coupled with directives to channel inexpensive credits to favored manufacturing sectors, whether through administrative guidance or by a more transparent process.

Another powerful way to enhance resource mobilization is to lower labor costs to below "market" levels. This can be done in two ways. One approach, widely adopted in East Asia after World War II, involves the prohibition of collective bargaining, allowing firms to use their superior bargaining power to hold wages down until full employment is reached and perhaps to bargain aggressively even afterwards. Obviously, this involves the repression of labor unions and worker rights to collective bargaining. A similar effect can be achieved through coordinated bargaining involving peak organizations for business and labor, often under the auspices of government. The logic of such agreements is that labor and business representatives recognize the need to raise the share of income received by capital in order to create increased incentives for investment. Temporary wage restraint can lead to increased profit margins, increased investment, increased productivity growth, and increased incomes, or long-term gains for a short-term sacrifice. It is based on the recognition that excessively high wages tend to "starve the goose that lays the golden egg" and that collective action can achieve wage restraint more effectively than independent bargaining at the level of the firm.

There are a number of ways to increase prospective returns, but reducing factor costs for labor and/or capital is absolutely key to success. For this part of the strategy to work, there needs to be a socially acceptable rationale, including how it will benefit labor as well as capital. In addition, business leaders have to accept a measure of societal responsibility that is not congruent with shareholder capitalism and extraordinary executive compensation along the line of the post-1970 US experience. I will explore the Swedish example at length to show this was accomplished in a developed democracy, albeit in circumstances quite unlike those since 1960.

None of the above ideas require state ownership of industry. Yet such ownership should not be excluded if the urgency of the problem is great enough to serve as a deterrent to a culture of corruption.

The aim of EM is to initiate a "virtuous circle" as higher investment results in production of increasingly sophisticated goods and services as well as increased economic growth, and enhanced growth begets higher investment, including in higher education. This high investment, high growth "development path" enables new technologies to be developed and diffused more rapidly, higher value-added production to grow (at the expense of traditional sectors such as agriculture and then low value-added manufactures), and productivity to be progressively lifted. In addition, it appears that wage restraint can boost profits, investment, and productivity growth, and that once this pattern has set in it permits above average pay increases with little impact on unit labor costs, thus tangibly including workers in the virtuous circle. EM can thus boost growth and employee compensation without compromising overall external competitiveness. Beyond these broad ideas one can identify some more precise supporting measures.

Supporting Measures

Rapidly growing economies pursuing EM strategies must put in place a range of supporting measures to avoid balance of payments difficulties (sparked by rapid import growth) and excessive domestic inflation (due to credit expansion). These supporting measures typically include:

- *Measures to curtail credit for consumers so that the increased resources are drawn more toward producer goods and services*. High down payment requirements for home mortgages, for example, force consumers to increase their saving and cut back on consumption expenditure. An absence of credit cards or consumer loans is another measure to limit consumption. Taiwan made it a crime to bounce a check, encouraging consumers to keep a positive balance in their accounts. At the same time, lower wages (as a share of GDP) limit the growth of consumption spending (as a share of GDP). Typical saving rates in East Asia in their high-growth years were about 40% of GDP, or roughly double those in the rich industrial countries.
- *Strong measures to support export growth to lift the "balance of payments constraint."* Faster growth in domestic demand can be expected to induce increased

imports, and often at a faster rate than the growth of aggregate GDP, risking a balance of payments crisis. As a result, the EM strategy requires strong export growth if it is to maintain a satisfactory balance of trade. Exports can be encouraged through targeted incentives (e.g., rapid recovery of credits extended on export sales) and the lower factor costs that domestic producers face (for example, reduced land costs). Probably the most powerful of such cost reduction measures is the prohibition of labor unions, which keeps wages lower than otherwise in a high-growth economy. Reducing factor costs relative to GDP enhances export competitiveness much like currency devaluation, but it is superior in that the currency retains its external purchasing power, thereby holding down import costs.

- *Selective use of industrial policies that favor certain industrial sectors, shifting emphasis from low to progressively higher value-added, and typically more knowledge-intensive activities, as incomes rise and technological capabilities increas*e.
- *Measures to ensure the benefits of EM are not lost to the economy.* EM implies the creation of economic rents in the industrial sector in order to induce added risk-taking by the relevant firms to acquire or develop new technologies and to invest in their development. If these rents are not to be lost to the economy, banks as well as non-financial firms need to be insulated from foreign takeover, and the financial system needs to run largely on bank credit rather than arms length transactions in capital markets. In addition, safeguards must be put in place to ensure that the added profits are reinvested in productive activities within the country, and not exported abroad or paid out as excessive dividends or salaries. (These measures obviously invite attack from those advocating free trade, and notably from high-income economies that have surplus capital looking for foreign takeovers.)
- *Increased investment in basic education and healthcare of domestic workers*. Basic education means the first 12 grades, and it means teaching critical thinking as well as the three R's, so that people can learn to play an educated role in civil society as well as earn a living. These public services are often undersupplied, limiting a society's capacity to raise its productivity and ensure that the benefits of growth are widely shared.
- *Sound fiscal and monetary policies that ensure the stability of the domestic economy.*

EM strategies, if correctly applied, can deliver decades of economic growth and lift countries out of poverty. But it should be clear from the above discussion that these strategies are only likely to be successfully implemented in rather austere and/or demanding circumstances, and by people who are both capable and dedicated. Low relative income might seem to provide the rationale for a strategy of enhanced mobilization in order to catch up, but in practice it has not proven nearly adequate in terms of motivation. Even in low-income societies or regions, there are usually those who can profit by skimming rents from their poorer neighbors instead of working toward building a better life for all. This is what one should expect from a society like the oligarchies to be found all over Africa and Latin America. On the other hand, continuing denial by the multilateral agencies that such a strategy exists, or claims that if it did exist it would be too difficult to implement, mean that there is no accepted notion of the EM strategy in the literature. To call the Washington Consensus a strategy for export promotion, as though this added much to the understanding of what happened in East Asia, is to make a mockery of the ingenuity shown by the East Asians. And, as far as I am concerned, the "accelerated accumulation strategy" is a new label for a well-known wine (i.e., the Washington Consensus).

There have not been many countries that have been able to implement EM strategies. However, I believe it is notable that all of the high-growth strategies in East Asia were based on the principles outlined above, starting with Japan and ultimately including Korea, Singapore, and Taiwan in a group that was identifiable by the mid-1960s. China and Malaysia more recently deserve a similar classification, and especially China; this designation would only apply for Malaysia since the New Economic Policy of the 1970s, and for China since the 1978 economic reforms. The World Bank, in its report on the East Asian Miracle, also included Hong Kong, Indonesia, and Thailand among its high-performing countries. I find these additions problematic, in terms of meeting the preconditions as well as in terms of their strategies. Hong Kong, for example, benefited from a massive influx of capital and skilled labor as the former Chinese elite fled the mainland, requiring little but British protection, provided by an unelected local government, to allow it to enjoy enhanced mobilization. Neither Thailand nor Indonesia faced the implicit military threats faced by China, Korea, Singapore, or Taiwan, and Indonesia has been resource rich and corrupt to boot. Moreover, neither Indonesia nor Thailand moved as decisively to mobilize their human and financial resources, and their inclusion as though comparable to the other countries obscures rather than illuminates the "East Asian Miracle."

Looking outside of Asia, we can see that parts of the EM strategy have been used to powerful effect within Europe since World War II, initially in Germany and the Netherlands. In the mid-1980s, much the same approach was used in Australia and Ireland. Interestingly, Czech labor unions offered a period of wage restraint to help launch the new regime in 1991, only to have their proposal rejected as unnecessary by the Klaus government. There have been other cases, but in my view the most remarkable and unexpected case is that of Sweden, which we will explore immediately below.

Applying Enhanced Mobilization Strategies

In this chapter I will illustrate EM strategies in three ways. First, I will very briefly illustrate some elements of the EM strategy with an American example already discussed in Chap. 7, as a reminder that such ideas can and have been applied in the United States, namely, when it was a developing country with a great challenge to revive its economy after a war of liberation. In this instance, the United States was blessed by unusual leadership in the person of its chief economic officer, Alexander Hamilton, with the full support of George Washington. Furthermore, there were an array of supportive actions that were spontaneously undertaken by state legislatures and their respective courts, as explained in Chap. 7. Second, I will examine the strategy of Sweden from about 1905 until about 1960 as the exemplar of enhanced mobilization in a liberal democratic context. Since this is such a powerful example in a very unlikely setting, I will treat it at much greater length. Third, I will consider several examples of collective action to achieve below market labor costs in the context of liberal democracies. Once the application of a reduced version of this model is illustrated in these familiar contexts, it will be easy to understand how similar results were achieved in non-democratic circumstances in East Asia. Finally, I will outline several approaches taken to reduce capital costs and to allow firms and financial institutions to take added risks, effectively shifting risks to the state and ultimately to the taxpayer.

I give brief attention to technology acquisition, domestication, and diffusion in order to identify various forms of intervention that have been used, but make no attempt to document their success. I will not give much attention to the development of human capital, surely less than it deserves, because Asian performance in this domain has been very strong and is well understood. And I will not attempt to be comprehensive in the identification or analysis of what I call producer-oriented institutions—another key element of EM strategies. I will remind the reader that these have been given some attention in the chapter on the US economic development between 1630 and 1830 (Chap. 7). Instead, I will concentrate on the instrumental role of banks in the EM strategy, as well as the need for limits on foreign takeovers if the strategy is to work.

EM as a Response to Market Failure?

As mentioned earlier, the EM model assumes the presence of market failures that, if left unattended, can inhibit growth. The complex challenges of acquiring new technologies, training workers, and mastering new production processes are both costly and risky, especially in a developing economy. If these costs and risks are borne by the private sector, as they usually are in the normal course of events, they can inhibit the pace of investment and development. For example, a highly respected source of financial analysis currently estimates that net returns on investment in the United States are 3–4% above the cost of capital, an unusually wide margin implying that profit opportunities are not being fully exploited.[3] While this may or may not be a significant issue for the United States, it surely would be for a developing country, and especially if the gap were even wider. EM is a strategy to offset such gaps and/or risks by adding incentives, including shifting some risks from producers to

[3] See BCA Research, formerly the Bank Credit Analyst, an investment advisory service based in Montreal in various issues of their monthly letter on the US markets.

consumers or taxpayers. Tilting the market frameworks, as explained in Chap. 2, can enhance the rate of resource mobilization so that the public good of accelerated modernization of the economy can be achieved. The logic is much the same as that of parents of modest means who save money to finance a college education for their children, such that they may have opportunities not enjoyed by the parents. While the theory of rational expectations might say that any such parent is not sufficiently self-interested, cultural norms of trying to provide a better life for one's offspring can have a certain currency among thoughtful people nonetheless.

Where to begin? The obvious place to turn for an exploration of the strategies of enhanced mobilization would be East Asia, where the leading practitioners of recent decades are located, and whose successful experiences are well known if not always well understood. However, it is easy for many Westerners to have reservations about the applicability of these East Asian models, since they were not, at least for the most part, launched by liberal democratic governments. Furthermore, the data sources are often less complete than we might wish, especially when it comes to data on corporate profitability, except in Japan. So I propose to emphasize here examples from liberal democratic societies even though they have typically made much more limited use of the core ideas in this model. Sweden merits particular attention because it used coercion (employer lockouts) within a democratic context as well as exchange controls and an absence of a market for corporate control, all of which resemble key elements of the Asian systems. In addition, there is some remarkable data and analysis that allows one to see and understand what they did.

The examples that I have chosen from liberal democracies each achieved enhanced mobilization through the moderation of wage costs, thereby enhancing corporate profitability, investment, and growth. Enhanced corporate profits also enhanced saving, especially in Sweden, where unusual Swedish laws allowed firms almost unlimited depreciation and the possibility to reinvest corporate profits tax free. On the other hand, dividends had to be paid out of after-tax earnings. This was not only a way to promote saving and investment but also a way to promote both directly within the firms, without the need for intermediation by banks or capital markets. Wage moderation was typically accompanied by other measures that varied from case to case; I do not give these other measures the space that they would merit in a more systematic analysis of the respective country strategies.

I have chosen Sweden as the lead case because it seems to have made remarkable use of wage moderation for about 50 years, circa 1910–1960, and to demonstrable effect. Sweden added wage solidarity as a necessary means to secure union support for wage moderation that took place at the short-term expense of their members, and to give an added form of implicit subsidy to Sweden's more knowledge and capital-intensive sectors. This appears to put Sweden in unfamiliar company with less liberal and less democratic regimes, while at the same time it was a model of high growth.

An Early American Example of Enhanced Mobilization

The United States is often seen as an exemplar of free markets, democracy, and private enterprise. This is a useful perspective, but only for US policy in the post-World

War II context and after the United States was the richest, most powerful economy in the world, a position it had enjoyed since roughly 1900. It is an inadequate perspective on US policy during the years that it was a developing country. When the 13 colonies earned their independence from Britain, they were in a weak position as far as defense was concerned. They had almost no standing army or navy, a population smaller than Britain and less than half that of France, and a new untried form of federal government that granted certain powers to the central government while reserving many others to the states. Like many a developing country in recent times, the new central government had little power to raise funds from domestic taxation, had to rely on import duties and land sales to finance its needs, and had a very large debt incurred to fight the war. In these circumstances, Alexander Hamilton, the new Secretary of the Treasury, articulated a core idea that contrasted with the writings of Adam Smith. Instead of allowing markets to have complete leeway to guide where investments should go and implicitly to develop existing advantages, he proposed to use the powers of the state to actively diversify the economy. Part of his reasoning was as follows:

> [T]he results of human exertion may be immensely increased by diversifying its objects. When all the different kinds of industry obtain in a community, each individual can find his proper element and can call into activity the whole vigor of his nature; and the community is benefited by the services of its respective members, in the manner in which each can serve it with most effect . . . To cherish and stimulate the activity of the human mind, by multiplying the objects of enterprise, is not among the least considerable of the expedients by which the wealth of a nation may be promoted . . . The spirit of enterprise, useful and prolific as it is, must necessarily be contracted or expanded, in proportion to the simplicity or variety of the occupations and productions which are to be found in a society. It must be less in a nation of mere cultivators than in a nation of cultivators and merchants; less in a nation of cultivators and merchants than in a nation of cultivators, artificers, and merchants.[4]

Hamilton was not proposing a free-trade regime let alone laissez-faire. Instead, he was proposing tariffs both as a primary source of revenue and as a source of protection for infant industries. While differing from Smith, he was far from creating a new scheme from scratch. Some of the key ideas of which he was aware had been developed in the Republic of Venice in the late Middle Ages, elaborated by the United Provinces (the Netherlands) in the 16th and 17th centuries, and further developed by Britain well before the time of Adam Smith. As an avid reader with a background in international business, Hamilton was doubtless aware of this earlier history in addition to the writings of Smith.

Hamilton's proposition for the value of diversification into manufactures to open up entrepreneurial opportunities was designed in part to increase the mobilization of labor by making the United States more attractive to immigrants, and especially to potential immigrants with unusual talents. He proposed to use treasury bonds as a way to increase the mobilization of financial resources. Specifically, he proposed to fund all of the war debts of the previous government, set up under the Articles of

[4] From Hamilton's "Report on the Subject of Manufactures," quoted in James Willard Hurst, *Law and Markets in United States History* (Union, NJ: The Lawbook Exchange, 2001), 15–16.

Confederation, and also the remaining war debts of the various states, with treasury bonds to be backed by the taxing power of the new government. In order to create a liquid market for these bonds, he proposed to create a Bank of the United States to operate such a market. It was his idea that readily marketable bonds would form a large new source of credit to supplement a very limited money supply based on gold and silver; these bonds would provide an investment vehicle for private banks, allowing them to earn money on deposits even in the absence of an adequate flow of private demand for loans, thus allowing the private sector to mobilize additional funds. Hamilton also aimed to enhance the returns in manufactures by the enactment of a protective tariff specifically aimed at manufactured imports. Throughout, he was following a recognizable model developed by Britain at the end of the 17th century and perfected under Robert Walpole, the Chancellor of the Exchequer and effectively the first Prime Minister, early in the 18th century.[5] Hamilton did not propose to reduce capital costs to below market levels, but his program to fund the debt at par, in spite of the large discounts then prevailing in the markets for these bonds, immediately established the credit of the new government, increased the capital resources available to the former colonies, including subscriptions by foreign investors, and helped reduce interest rates, thereby reducing the cost of capital. His proposed protective tariff was scaled back to a 5% revenue tariff until the onset of the War of 1812, whereupon tariffs were greatly increased. Thus, some of the core ideas of the enhanced mobilization strategy were present in his program to finance the new government as well as in his Report on Manufactures, and most of them were accepted by the Congress.

Within the early United States, Hamilton was not alone in his strategy for enhanced mobilization of resources. State legislatures modernized existing institutions by discontinuing feudal inheritance laws, such as entail and primogeniture, so that real property would be more mobile, and they modified existing property rights to favor potential development of mill sites, as explained in Chap. 7. At the same time, competition among states to develop their own resources led each state to watch the others and to copy valid ideas in short order. Thus, institutional innovation was taking place at the federal level and also through state governments, through the judicial branch as well as the executive and legislative branches. Many of these ideas would carry on into the 19th century and, as shown in Chap. 13, the United States would aptly become the world leader in public education thanks in no small measure to Jefferson's genius in sponsoring the Northwest Ordinance with its provision for financing public education.

Nevertheless, in its early years the United States was a high wage country, as there was an abundance of land waiting to be exploited, and so its example here is rather exceptional. One can get quite a different perspective on the enhanced mobilization strategy by looking at how it was applied in a country with far lower wages and that was losing workers through emigration, especially to the United States: Sweden.

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[5] Elkins and McKittrick, *The Age of Federalism*.

Swedish Wage Restraint and Solidarism as Enhanced Mobilization

Sweden has long been known for a distinctive "solidaristic" approach to coordinated wage-setting that could be roughly characterized by the notion of equal pay for equal work. Relatively less known is the fact that Sweden began its coordination of wage-setting, circa 1905, at the initiative of firms that were trying to achieve wage restraint in order to boost profits, saving, and investment. As the idea of coordinated, industry-wide bargaining became institutionalized, well-organized labor unions negotiated centralized wage deals with their equally well-organized employer counterparts, both over wage levels and skill differentials. The firms wanted the average levels reduced and the unions wanted the skill and/or sectoral differentials reduced. Over time they both had their way. By the early 1930s, all sectors were linked in a national wage deal. In this system, the average wage level was kept below what might be called the market clearing level, thereby creating something of a labor shortage. At the same time, pay differences across firms and sectors were reduced, reflecting the unions' promotion of the solidaristic notion of "equal pay for equal work." The marginal productivity of labor and firms' capacity to pay—at least in the model's purest form—were pushed to the background.

For many commentators, Sweden's solidaristic wage model was a byproduct of its strong labor movement and the long-established power of its Social Democratic party, which, with two rather brief exceptions, has dominated Swedish politics since 1932. Indeed, Swedish solidarism is often considered emblematic of its socialist system, even though it did not start out that way. Instead, it was business leaders who pushed for industry-wide bargaining to hold down wages as the key to a remarkable strategy that would allow Swedish firms to raise their profits, rates of investment, and productivity levels. The unions responded by asking for solidarity across job classes, across firms, and eventually across all industries as a concept that would allow them to mobilize the support of their members.

Supporters of this system highlight its egalitarian outcomes and cooperative (rather than confrontational) dynamic. They also point out that, between 1870 and 1970, Sweden achieved the highest economic growth rate in the world. Critics, meanwhile, decry, first, solidarism's insulation of pay scales by firm and by industry from market and commercial imperatives and, second, the rigidities it would build into the wider economy, e.g., the reluctance of workers to relocate to urban areas for better job opportunities when they could not receive higher pay for so doing. Critics also point to the fact that this system was created in part by a heavy-handed alliance between organized labor and a government that was dominated by the Social Democratic Party for more than 40 years, beginning in 1932. They also note Sweden's relatively less impressive economic record since 1970 in support of this thesis. But the system was largely in place and working more than a decade before the socialists had a role in government and about 30 years before they were able to govern alone, without an alliance with the Farmers' Party. Sweden's performance post-1970 is a different matter, as the underlying rationale of the system was turned upside down during the 1960s, a point to which we return later.

The following historical survey will argue that both interpretations miss the basic rationale behind the system's inception: to enhance the mobilization of human and financial resources within Sweden as a way to stem emigration. (In spite of such efforts, Sweden experienced about a 25% loss of population between 1870 and 1930.) In addition, they miss some key elements in the development of the system and its impact on the Swedish economy. As we will see, Sweden's employers played a critical role in the development of that country's centralized wage-setting arrangements. Solidarism, from its inception until some point in the late 1950s, was anchored in the idea of keeping Sweden's industrial wages in check in order to boost profitability, competitiveness, economic growth, and employment. I will develop this case study in some detail because it is a remarkable example of tilting labor market frameworks toward producers within a democratic country, and one that had Social Democratic party leadership for more than half of that period.

At the same time, it is important to acknowledge that Sweden's strategy ceased to be one of enhanced mobilization once its Socialist party garnered parliamentary majorities on its own, i.e., without the Farmers' Party as coalition partners. Its Social Democratic Party had little interest in competitiveness and, by 1982, would propose a system of worker ownership of industry that, if adopted, would have risked crippling not only its remarkable levels of productivity but also its capitalist system. It is the period 1910–1960 that interests us in this analysis, a period during which Sweden had a strategy of enhanced mobilization of resources and a growth record that foreshadowed those that were appearing in East Asia.

The Beginnings of Wage Restraint: Employer Lockouts

At the start of the 20th century, Sweden faced two main competitive challenges. Those of its manufacturing sectors that were exposed to the world economy (e.g., paper, chemicals, and engineering) faced stiff competition from more efficient and technologically sophisticated competitors in Germany, the United States and the UK. At the same time, Sweden had a good system of public education, so its workers could emigrate for better opportunities in other countries, and notably in the United States. While the highest rates of out-migration were recorded in the late 19th century, over 500,000 people, or about 10% of the population, emigrated between 1900 and 1930.[6] All told, the out-migration from 1870 until 1930 was about 25% of the population. Sweden thus also had a societal problem. How was Sweden to become a vibrant and competitive society where its children could find opportunities to develop their talents without emigrating?

There was a dilemma to be faced. As Peter Swenson points out, "Swedish employers, especially in engineering, recognized the acute need to increase both

[6]The exact figure is 519,666. Sweden's population was 5,136,441 in 1900 and 6,142,191 in 1930.

productivity and wages to be competitive internationally."[7] Swedish productivity, which at this time lagged well behind the levels of its main competitors and at only 40% of US levels, needed to be dramatically lifted. To do this, Swedish industry needed to boost its rate of investment relative to its competitors. In a market economy this would require increased profits to induce increased investments. One possibility was devaluation, but in a small economy this would raise input costs throughout and threaten inflation as well. Another possibility was to reduce wage costs. Wage restraint would enable Swedish firms to increase their investments in new technologies as well as their productive capacity. Ultimately, however, wages had to rise to stem out-migration.[8] The dilemma was the need to reduce wages in the short term to then increase them in the long term. How could this be accomplished in a way that would induce Swedish labor to be patient because they could see a better future ahead?

When employers came to recognize the vulnerability of Sweden's economic position, they took matters into their own hands. Their idea was to force a moderation in wages until they were below market clearing levels, thereby achieving higher profits with which to finance added investments per worker, boosting productivity, and thus permitting much higher wages over time. To succeed, there had to be solidarity on the employer's side, not just to offset that among its nascent unions, but also because some firms and sectors could do just fine with existing wage levels. In addition, there had to be employer loyalty to the country in the sense of investing increased profit margins within Sweden. In a context where Russia was a near neighbor, and World War I would prove to be a close call for Swedish neutrality, there was little need to remind Swedish employers that there were priorities beyond the wealth of their immediate shareholders.[9] Sweden had world class firms in weapons manufactures as well as explosives and ammunition. In addition, Sweden had two powerful family groups with important interests in many firms, helping to create a context where hostile takeovers were virtually nonexistent. In this context, profitable firms could reinvest to enhance the economic power of their country, the returns of their shareholders, and the careers of their employees. It was a fortunate coincidence, but not an easy one to exploit. Coordinated action was required if Sweden's market frameworks were to be tilted to favor its producers.

In framing their strategy, key business leaders had to take into account the highly "imperfect" nature of the Swedish labor market. What was the market failure? A key culprit was the high economic rents earned in three Swedish industry sectors: building and construction (which was not exposed to foreign competition), pulp and paper production (which benefited from Sweden's rich forest resources), and iron

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[7] Peter Swenson, *Capitalists Against Markets: The Making of Labor Markets and Welfare States in the United States and Sweden* (Oxford: Oxford University Press, 2002), 77.

[8] Ibid.

[9] In addition, at least in the post-World War II era, Sweden had capital controls, so extra profits would not likely flow abroad. Swenson does not mention these controls and I have not been able to find when they were initiated.

Table 12.1 Relative hourly earnings for manual workers, various sectors, 1970 (average for all industry in each country = 100)

	Sweden	USA
Clothing	79	71
Textiles	85	73
Shoes	87	73
Leather products	90	78
Beverages	94	109
Food processing	95	93
Wood products	96	86
Chemicals, oil, and plastics	96	113
Rubber	97	96
Quarries	101	101
Pulp, paper, and paper products	101	103
Engineering	103	110
Iron and steel	105	121
Auto industry[a]	110	126
Publishing	112	117
Mining and minerals	120	115
Building and construction	131	157

[a]The automobile industry is a subset of engineering.
Source: Ingvar Ohlsson, "Den solidarisk lönepolitikens resultat," in *Lönepolitik och solidaritet-Debattinglägg vid Meidnerseminariet den 21–22 February 1980* (Stockholm: LO, 1980)

ore (Sweden had Europe's richest iron ore reserves). Some indication of these imperfections can be seen in the relative wage levels paid by various sectors much later, as compared to their American counterparts, in Table 12.1. Employers in these profitable sectors typically offered less resistance to employee wage demands and were resistant to calls for collective action because it infringed on their rights to run their firms as they saw fit. However, higher wages in these parts of the economy would ripple outward, feeding into wage claims in other sectors and (by attracting labor from elsewhere) tightening the Swedish labor market. In addition, well-organized unions with large strike funds were able to intimidate individual employers in labor negotiations, particularly through use of secondary boycotts.

The employers' strategy was to embark on collective action of their own. In the first decade of the 20th century, Swedish employer groups initiated a series of industry-wide lockouts.[10] Engineering employers locked out 13,800 workers in 1905, with 7,780 of them union members. Similar action was taken by iron and steel employers and sawmill operators in 1907 and 1908, respectively. In 1909, Sweden's peak employer association (SAF) threatened to lock out 82,000 workers, or roughly 1.48% of Sweden's population at that time.[11] (If the same threat were issued by US

[10]The following historical survey draws heavily on Swenson, *Capitalists Against Markets: The Making of Labor Markets and Welfare States in the United States and Sweden*.

[11]Sweden's population in 1910 was 5,522,493.

employers today, about 4.33 million workers would be put at risk.) Labor leaders, under pressure from militant workers, responded by calling a general strike. This action rapidly drained the financial reserves of the unions and brought the organized labor movement to its knees. In the aftermath, union membership was cut almost in half.[12] These lockouts were intended to achieve a range of objectives, including stronger management control of the production process, the "downward leveling" of wages across firms (within particular sectors), and the phasing-out of non-cash worker benefits (e.g., company supplied housing). They were particularly useful when labor markets were tight. By undermining the unions' financial resources (as they provided support to locked-out workers), lockouts reduced their capacity to strike for higher wages.[13] But the lockouts were not intended to break the unions, far from it.

During this period, employer groups proved remarkably successful in achieving their objectives. Industry-wide understandings on wages, conditions, and management prerogatives were enshrined in a series of labor agreements, which by 1920 had spread to all key sectors of the Swedish economy.[14] It is worth pointing out that unions were seen as essential partners, not enemies. When some employers talked of supporting legislation to outlaw secondary boycotts, or boycotts of firms not directly engaged in a labor dispute, employer leadership refused to go along, reasoning that any such move by government could pave the way for restrictions on their use of the lockout. The employer strategy was to discipline the unions, but not to break them. Unlike their counterparts in the United States, Swedish employers opted against hiring non-union labor. Indeed, after the 1909 general strike, the main employer organization (SAF) passed up an opportunity to crush the union movement due, at least in part, to its fear that it would be replaced by radical syndicalists (organizations which did not pay workers during lockouts and therefore were less threatened by the use of this "weapon").[15] By signing onto centralized agreements, union leaders were better able to discipline their militant members. Agreements also encouraged discipline within employer ranks; many included provisions limiting employer competition over labor (for example, by offering above "normal wages" or illegally poaching workers).

By the early 1920s, Swedish employer organizations had succeeded in securing employer cooperation so that they could centralize wage determination with the relevant unions within key industry sectors. They had not achieved the same across industries, a critical gap. Given the widely different market conditions faced by each sector, pay agreements which made sense in one part of the economy—by being used as precedents for agreements in other sectors—could cause disruption elsewhere. In the next phase of our story, we will see how Sweden's peak employer body (SAF) managed this issue.

[12] Swenson, *Capitalists Against Markets*, 84.
[13] Ibid., 78.
[14] Ibid., 86.
[15] Ibid., 84.

Wage Restraint and Solidarism: Reducing Wage Differentials Between Sectors

By the mid-1920s, there was increasing recognition that escalating wage differences between "sheltered" (i.e., non-traded) and traded goods sectors were posing difficulties for the Swedish economy. The most conspicuous non-traded sectors were building and construction and food processing. In Stockholm, for example, bricklayers were paid over twice what skilled metalworkers received.[16] While high construction costs were at least partly attributable to climatic conditions (with productivity dropping dramatically during long Nordic winters), the absence of any import competition allowed employers in this sector to pass wage (and other cost) increases onto consumers and especially onto other businesses. As a result, "unprotected" sectors were forced to absorb higher input costs and fend off pressures from their own workers for "commensurate" wage hikes. These pressures mounted during the 1920s, when a construction boom resulted in significant wage increases in this sector, widening the already-large wage gap with other parts of the economy.[17]

In 1933, less than 12 months after the election of Sweden's first Social Democratic government, the SAF decided to act. Resorting to its favored weapon, employers threatened a massive sympathy lockout to end a 10-month dispute in the building and construction sector. Sweden's peak labor organization, not well disposed toward the "militant" construction workers and fearing compulsory arbitration, eventually succeeded in convincing construction union leaders to agree to a deal they had earlier rejected. Under this arrangement, wages were cut to below 1922 levels, piece rates were reduced and simplified, and opportunistic strike actions were outlawed.[18] Construction wages were brought into line with those of other sectors, bringing "a more compressed, solidaristic pay structure across industry lines."[19]

This second phase of wage restraint had two important implications. First, by reducing wage differences between sectors, based upon the principle of solidarity, the resulting wage curve represented an implicit subsidy for highly productive firms and sectors and an implicit tax on their less efficient counterparts, as shown in Fig. 12.2.

The effect was to tilt the labor market to favor the former, typically higher technology and faster growing sectors such as chemicals, autos, and other kinds of machinery. For the unions, the principle was solidarity, which had a strong appeal to their members. Second, by forcing down the average wage rate relative to the market clearing rate, or that in the manufacturing sector in competing countries, e.g., Germany, wage restraint created a "below market" wage and effected an implicit transfer of income from labor to capital, setting the scene for continued high rates

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[16] Ibid., 101.

[17] Ibid., 101–102.

[18] Ibid., 100.

[19] Ibid.

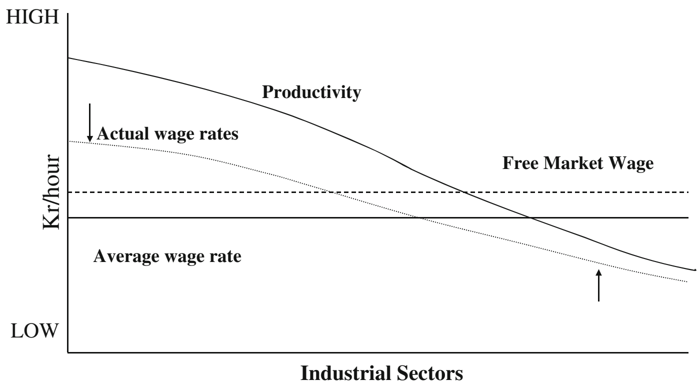

Fig. 12.2 Sweden: use of centralized wage policy to accelerate adjustment. Note: The arrows in the diagram suggest the direction in which solidarism pushed wages relative to paying for productivity. Source: Author's sketch, based on text by Jonas Pontusson, *The Limits of Social Democracy: Investment Politics in Sweden* (Ithaca, NY: Cornell University Press, 1992), 60

of investment and productivity growth. Later, the Swedes made use of a formula for setting manufacturing wages, the so-called EFO model, named after the first initial of the last names of three economists who had devised the formula.

The concept of solidarity allowed the unions to justify holding wages down in high-productivity sectors while pushing up those in the low performing sectors. Employer associations disapproved of employers in low-productivity sectors who might try to pay unusually low wages as a way to survive. The idea was to force all employers in low-wage/low-skill sectors to modernize or die. At the same time, the large gap between productivity and actual wages in the high-performing sectors implicitly subsidized the high-growth sectors at the expense of older sectors such as textiles, foot wear, wood products, food processing, and so on, and would help shift jobs and employment toward the higher productivity sectors. The effect of wage solidarity on the sectors with above and below average wages is shown below in Fig. 12.3. In addition, one can see that Sweden's wage structure was more egalitarian than the American from Table 12.2. Whereas the United States had five sectors where wages were more than 110% of average and another five sectors that were less than 90% of average, Sweden had only three sectors with wages below 90% of average and only three that were more than 110% of average. While Sweden was and remains a small and ethnically more homogenous country, it nevertheless had some big sectors that still earned so-called mining rents in spite of the fact that its compression of inter-sectoral differentials had started 50 years earlier.

While wage restraint and solidarism played important roles in improving Sweden's economic performance, other factors also had an impact. The large depreciation of the Swedish currency in September 1931 (as it followed Great Britain off the gold standard) provided significant stimulus to the domestic economy. And

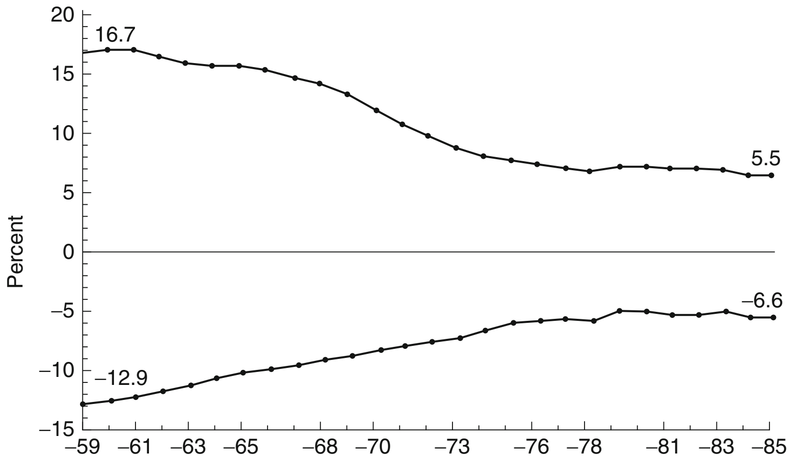

Fig. 12.3 Sweden: wage differentials for sectors with above and below average wages, 1959–1985. Note: The straight line represents the average wage of workers covered by LO-SAF agreements. The upper curve represents the average wage of the "contract areas" (typically defined by industrial sectors) that lie above the LO-SAF average in a given year and the lower curve represent the average wage of the "contract areas" below the LO-SAF average. (All together there are 120 contract areas.) Source: Elvander (1988:36) as cited by Pontusson in *The Limits of Social Democracy*, 1992, p. 69

in the post-World War II period, a range of measures were adopted to lift private-sector investment, including accelerated depreciation on fixed capital, incentives to reinvest profits (rather than pay them out as dividends) and controls on capital outflows.

The results of Sweden's wages and other policies were impressive. From 1870 to 1950, industrial employment in Sweden (as a percentage of total employment) increased from 21% to 40.8%, the largest increase in the developed world at that time. The corresponding changes for the United States, for example, were 24.4–33.3% and Germany, 28.7–43%.[20,21] Industrialization also brought with it rising incomes. From 1913 to 1950, Sweden's GDP per capita rose from $3,096 (16% below the Western European average for that year) to $6,738 (over 34% above it).[22] Higher incomes, in turn, stemmed out-migration and increased employment, as "excess labor" moved from the countryside into the cities, increasing worker

[20]Angus Maddison, *Dynamic Forces in Capitalist Development: A Long-Run Comparative View* (New York: Oxford University Press, 1991), 248–249.

[21]Angus Maddison, *Dynamic Forces in Capitalist Development* (Publication Details), pp. 248–249.

[22]Maddison, *The World Economy: A Millennial Perspective*, 264.

Table 12.2 Economic models compared

Model	World Bank: The Rapid Accumulation Model	Bruce R. Scott: The Enhanced Mobilization Model
Basic concept	A functional approach to growth based upon minimal intervention	A strategic approach to growth where consumers and workers subsidize producers. By reducing factor costs, this boost profits, corporate saving, investment productivity, employment, and growth.
Implicit goals	Economic efficiency, Maximum consumer welfare	Build economic power through higher incomes and thus higher powers of taxation
Policy choices		
– *Fundamentals*	– Stable macroeconomy – High human capital – Effective and secure financial systems – Limiting price distortions – Openness to foreign technology – Agricultural development policies	– Stable macroeconomy – Enhanced public goods for whole population – Education and health care – Law enforcement and regulation – Openness to foreign technology – Effective and secure financial systems
– *Enhanced Mobilization*	No enhanced mobilization	– Forced saving – Reduce factor costs through deliberate repression of interest rates and of collective bargaining to create economic rent for firms – Allowance for abnormal leverage for firms and banks – Controls on capital exports
– *Selective Interventions*	– Export push – Financial repression – Directed credit – Selective promotion (none)	– Directed credit – Selective promotion of sectors/technologies
Institutions	– Technocratic insulation – High quality civil service – Monitoring	Same as World Bank plus: – Credit-based system, with limited entry – No market for corporate control – Administrative guidance – Coordinating agencies for industrial policies

Sources: The Rapid Accumulation Model: The World Bank, *The East Asian Miracle*, 88; The Enhanced Mobilization Model: Bruce R. Scott support for centralized wage-fixing arrangements. Productivity also grew strongly. From 1913 to 1950, Sweden recorded a higher rate of productivity growth than any other developed economy.

Sweden's Wage-Setting System in the Post-World War II Context

While Sweden's strong productivity gains were sustained for some time after World War II, the national security justification for the system was eroding as Europe and the United States joined forces to create NATO as a defensive alliance to deter Soviet expansion. At the same time, the Europeans began integrating their economies in a market-based approach to increasing specialization and productivity. From 1960 onward, Swedish wage increases outstripped productivity growth, thus abandoning the wage-based pillar of its Enhanced Mobilization strategy as shown by the rising share of wages in national income (Fig. 12.4).

In 1974, Swedish wages were the highest relative to GDP among a sample of developed countries, and they would not return to a more normal level until 1994, as shown below in Fig. 12.5. However, rising unemployment, the usual market-based signal for wages that were "too high" did not flash a warning. Sweden's expensive labor was increasingly absorbed into the public sector, which increased its share of overall employment from 14.3% in 1963 to 30.3% in 1980.[23] Private-sector employment (despite short periods of growth) remained flat—no net private-sector jobs were created in the Swedish economy from 1950 to 1992! The balance of political forces had changed. From the 1930s to the 1960s, Swedish politics had been

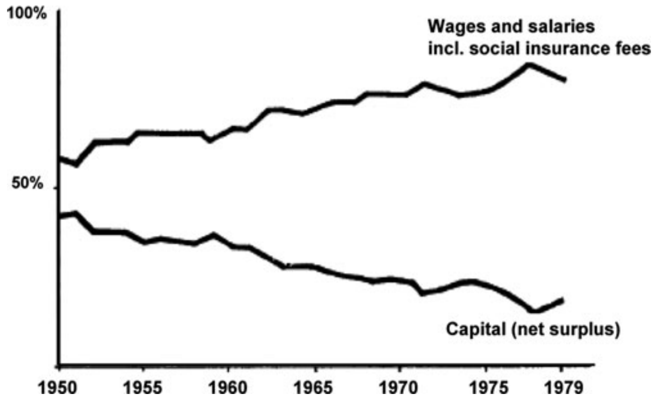

Fig. 12.4 Domestic factor income, 1950–1979. Source: National Central Bureau of Statistics

[23]Organisation for Economic Co-operation and Development, *OECD Economic Surveys 1991–1992: Sweden* (Paris: OECD, 1992), 132.

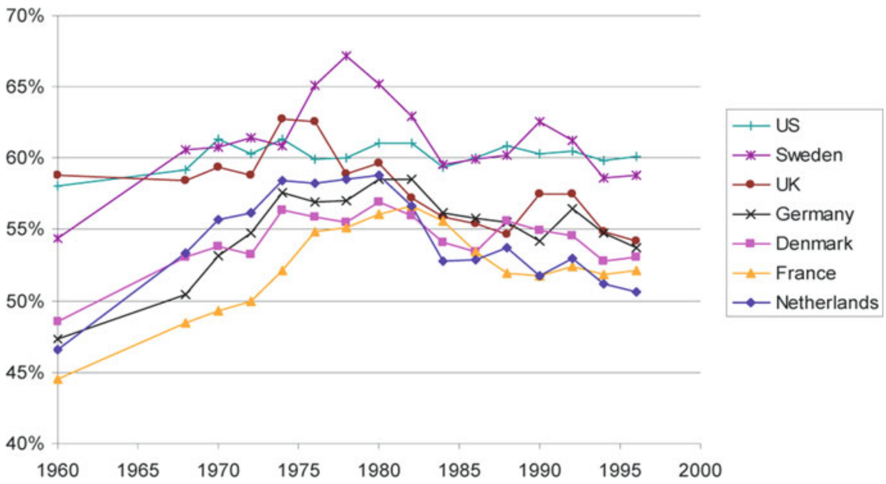

Fig. 12.5 Compensation of employees as a % of GDP, 1960–1996. Source: OECD

dominated by an alliance between worker and farmer representatives. From the 1960s onward, however, the former were the majority party in their own right, and thus able to enact socialist policies.

Sweden's centralized wage system conspicuously failed to adjust to the oil shocks of the early 1970s, shocks which drove up prices and wages and squeezed more jobs out of the economy. The proximate driver of the failure was political. The Social Democratic Party was increasingly sensitive to its increased party membership in services and the public sector, and these constituents were not much concerned about Sweden's international competitiveness. They wanted wage increases to offset price increases, period. So Sweden's average wages increased relative to its competitors'; profitability declined, investment relative to GDP declined, and productivity growth also declined. The system had gone into reverse, so to speak. If politics was the proximate cause for the reversal, the underlying causes were the end of a sense of concern for national security or for boosting productivity relative to other countries. There could still be a rationale for wage solidarity among a large fraction of the population, but there was no longer the reason for Swedish solidarity to tilt its market frameworks to favor producers.

From the mid-1970s onward, Swedish investment flowed toward services, which were mostly sheltered from foreign competition, and then housing, because Sweden still had capital controls that sharply restricted the right of its citizens or firms to transfer funds to other countries. However, as Sweden prepared to join the EU, it had to permit capital exports, and as this happened there was a rush for the exits, a collapse of real-estate prices, and a currency crisis. To stem the currency crisis, Sweden briefly raised interest rates to 500%, like a third-world country. This debacle would lead to devaluation and to calls for reform. With wages taking a higher share of GDP than other industrial countries, profits were obviously near the bottom, and the returns at home lackluster. Not surprisingly, Sweden's job creation in its private sector remained near zero, and its income per capita continued to fall relative to those of other developed economies.[24] However, its problems were not insurmountable, and they were gradually addressed during the 1990s.

Intervention to tilt market frameworks can serve a useful purpose, but no intervention, private or public, should be considered a recipe that will be valid indefinitely. There will always be the potential need for corrections. In this case the corrections might have included the search for a labor market framework that was approximately neutral relative to those in other relevant countries.

Sweden's experiences in the 1970s and 1980s are a case study in how a country could fail to adjust its solidarism to excessive wage growth, allowing its EM strategy to go into reverse to the point of de-industrializing the country. All the same, the Netherlands and Ireland provide powerful reminders of the reform potential of this strategy in just those latter years.

Solidarism in the Netherlands

In the early 1980s, the Netherlands found itself in deep recession. Gross domestic product fell for eight consecutive quarters, private-sector investment fell, one out of every 25 manufacturing firms went bankrupt, and unemployment shot up. By 1984, unemployment was nearly 14% of the labor force, and almost as many people had opted out of the workforce by taking early retirement or disability pensions.[25] Only a few years later, the stage had been set for a decade of strong economic growth, impressive rates of job creation, and a halving of the (1990) unemployment rate. What caused this transformation? While there were a range of contributing factors, a key development was a November 1982 agreement between the Netherlands' peak union and employer groups called the Accord of Wassenaar. Paradoxically, one of the key features of this agreement was that it was not legally binding on any of the parties; it provided a framework for sustained wage moderation and, over time, greater labor market flexibility. The power behind it was that of the moral force of a consensus on the need for coordinated action by business, labor, and government.[26]

The Dutch recession of the early 1980s concentrated the minds of key labor and employer groups. After a period of militancy in the 1970s, union leaders came to recognize that wage moderation was necessary for employment growth. The centerpiece of the Wassenaar Accord, therefore, was a recommendation that workers forego nominal wage increases (i.e., cost of living adjustments) due in 1983 and 1984. Employers, for their part, agreed to drop their opposition to negotiating a

[24]Sweden seems to have done remarkably well in terms of keeping up technologically without the usual capitalistic incentives such as bonuses and stock options, but this is part of another story.

[25]These figures, and others on the Netherlands, are drawn from Bruce R. Scott and Jamie Matthews, "The Netherlands: A Third Way?" Harvard Business School Case No. 702-015, originally published in 2001 and revised in 2003.

[26]Ibid.

reduction in the 40-h working week (shorter working hours were seen as an employment creating measure by the unions). And government and labor agreed to permit more part-time work. The results were impressive. By 1985, average real wages had fallen by 9%, employee compensation had fallen from 56.6% of GDP in 1982 to 52.9% in 1986 and 51.8% in 1990 (Fig. 12.5), and operating profits were up from 23.2% of GDP in 1982 to 27.3% in 1990. In addition, inroads were made into public sector wages and benefits, and consumption fell by 2% of GDP, making room for increased export capacity. Meanwhile, whereas investment had grown not at all from 1974 to 1985 in real terms, it increased a compound 3.7% from 1985 to 1990. And whereas employment in the EU grew 0.4% per year from 1983 to 1993, it grew 1.8% per year in the Netherlands over the same period. All in all, male employment grew from 69.1% of those of working age to 76.2% in 1990, while that for women grew from 34.7% to 47% over the same period. It was a spectacular set of changes, again with a cumulative effect much like that of a devaluation, but without reducing the external purchasing power of the guilder. The fact that the Netherlands was a small country made this option possible. (Germany would accomplish something similar in the 1990s to bring its wages back into line.)

After a further recession hit the Netherlands in 1992, peak union and employer associations signed a new Accord in December 1993. In addition to renewed commitments to wage restraint, unions agreed to greater decentralization and flexibility in labor arrangements, including increased part-time work. This was seen by both sides as a way to bring more Dutch people into the labor market, including women with child-rearing responsibilities. A further indication of growing labor market flexibility was the growth of "temporary" employment, i.e., people hired out to employers by temporary labor agencies. Indeed, part-time and flexible jobs accounted for three-quarters of all jobs growth in the Netherlands between 1983 and 1996. This growth was associated with broader structural changes in the Dutch economy, including strong growth in the services sector and among small firms (at the expense of manufacturing), rising female participation in the labor force, and welfare reforms (which tightened eligibility for sickness, disability, and unemployment benefits).

While the Netherlands faces continued reform challenges, its economic performance over the 1990s was impressive. GDP growth was significantly higher than the EU average. Unemployment in 2000 stood at 2.6%, compared to 12.4% in the EU and 4.1% in the United States. And the labor market participation rate had grown strongly (although much of this increase reflects the movement of women into the labor market). Significantly, these employment gains did not spark an increase in wage costs. The Dutch Central Bank has estimated that manufacturing labor costs in the Netherlands remained flat from 1983 to 1995, unlike France (where they rose by 2%) and Germany (2.6%). Finally, strong employment growth in the Netherlands was not associated with a significant increase in (incomes) inequality, in contrast to the experiences of the United States and the United Kingdom. In the Netherlands, as in Sweden, a strategy of wage restraint had been followed with strong performance.

In the Dutch case one could say that the strategy of wage restraint amounted to an informal devaluation, and was thus at some implicit cost to its neighbors.

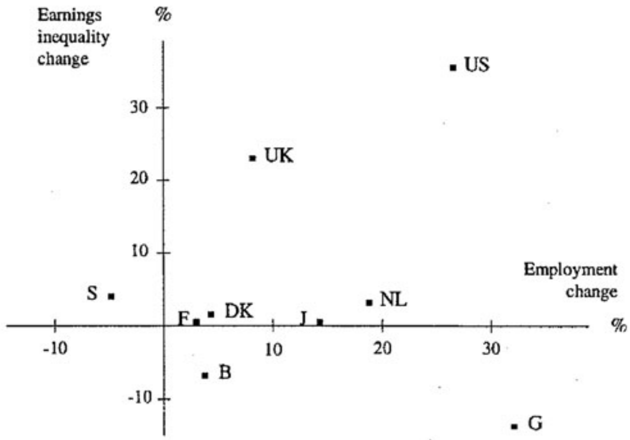

Fig. 12.6 Employment growth and changes in earnings inequality in the Netherlands and selected OECD countries, 1982–1995. Source: Jelle Visser and Anton Hemerjick, *A Dutch Miracle* (Amsterdam: Amsterdam University Press, 1997), 41

At the same time, it was superior to devaluation for Dutch consumers because their currency bought as much in the way of imports as before. The impact of this strategy on other countries became a good deal more serious when it was practiced by Germany at the end of the 1990s, helping to propel German exports and growth through increased cost competitiveness relative to its neighbors (Fig. 12.6).

Ireland

The economic transformation of Ireland since 1990 has attracted a great deal of attention. During the 1990s, this once stubbornly backward economy grew at 6.8% per year compared to the 2.0% average in the European Union and the 2.4% in the United States.[27] Its GDP per capita, which had been less than two thirds of the UK's in 1987, had almost drawn even with it 10 years later, and would go on to surpass it in the new millennium. Perhaps most heartening of all, Ireland's century and a half of emigration had been reversed in the 1990s; it could not only provide jobs for its children but was also attracting net immigration.

What explained such profound change? Ireland's sound fiscal and monetary policies, incentives to attract direct foreign investment, and generous subsidies from Brussels are usually cited as key contributors to this success story. However, Ireland's solidaristic approach to wage policy also played an important role. As we saw in Sweden and the Netherlands, centralized agreements between business and labor facilitated important economic changes.

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[27] In real, inflation-adjusted GDP. This section draws on Willis M. Emmons III, Adele S. Cooper, J. Richard Lenane, "1-800 Buy Ireland," Harvard Business School Case No. 799-132.

In the Irish case, the impetus for this approach was provided by an economic crisis that brought a newly elected Fianna Fail Government to power in 1987. With a budget deficit of 6% of GDP, public debt to GDP at 112% and among the highest in the world, gross investment down from 28% in 1980 to 17% in 1987, and unemployment at almost 14%, there was a need for draconian action to boost investment and employment while reducing government expenditure. Recognizing the need for a sustained period of wage moderation as part of the remedy, the new administration won employer and union support for a *Program for National Recovery*—a series of centralized agreements over the ensuing decade which set limits on wage increases and (once the economy started to improve) provided "offsetting" tax reductions and welfare benefits to employees. Wages as a share of GDP dropped from 53% in 1986 to less than 44% in 1996. In 1997 the OECD—usually a champion of decentralized labor markets—commented that these agreements had "generated moderate private-sector wage increases during a period of rapid growth, thereby maintaining Ireland's competitive position relative to its trading partners."[28] Ireland's solidaristic wage policy also ushered in a period of industrial peace. These labor market outcomes, in turn, helped Ireland market itself to potential foreign direct investors as a business-friendly location.

While many observers attribute Ireland's remarkable growth post 1987 to its ability to attract foreign investment, I believe this to be a simplistic view. True, FDI played a role in this strong growth, but its success in attracting FDI was also boosted by the wage restraint. From 1993 to 1997, for example, average hourly earnings rose by just over 10%, or five points below the average increase of its major trading partners. Unit wage costs, already relatively low in 1993, fell a further 23% by 1997. Those of its major trading partners rose slightly over the same period.[29] Ireland's more internationally competitive economy was able to sustain high-growth rates without running into balance of payments difficulties. And its emerging export-oriented industries tapped into a range of international markets, reducing Ireland's traditional dependence on trade with Britain. Investment grew at about 7% per year from 1987 to 1997, rising from 17% of GDP to 21%, leading some to refer to Ireland as a Celtic Tiger. Tiger or no, the new century would witness Ireland pass Britain, its old colonial master, in GDP per capita, while also becoming a magnet for immigrants.

Ireland's success story is quite remarkable by any standard, but all the more so since Ireland was a British colony for more than 600 years. Indeed, Ireland has an almost unique position among former colonies as a resounding success in its industrialization, a success that goes far beyond either increasing FDI or wage restraint. Despite having taught the Ireland case many times, and done a good deal of additional reading, I feel that its growth spurt has causes not captured by either or both of the explanations just offered. Indeed, for readers of this book, it might be richly

[28]Organisation for Economic Co-operation and Development, *OECD Economic Surveys 1996–1997: Ireland* (Paris: OECD, 1997), 3.

[29]Emmons et al., "1-800 Buy Ireland," exhibit 13.

rewarding to ask why Ireland was able to escape from the legacy of its colonial past in the 1990s, when the Mezzogiorno, with a similar colonial past, was not, as discussed in Chap. 9. In theory it should have been easier for the Mezzogiorno to show superior performance as a favored dependent of a vibrant democracy than for Ireland, which was somewhat more independent, though still heavily subsidized by the EU. Partial explanation is just that—not the whole story.

Australia

Australia, like the Netherlands and Ireland, used centrally coordinated wage bargains to moderate the growth of wages and facilitate wider economic reforms during the 1980s and 1990s. Once again, a sense of national crisis was the spur for action. After a decade of high inflation and unemployment, a newly elected Labor (i.e., social democratic) government negotiated an Accord with key labor and employer groups in 1983. This agreement, and the ones that followed it, secured union support for wage moderation (in return for tax breaks and other government assistance) and industrial peace. This was no small achievement. From the early 1960s to the late 1970s, the share of national income allocated to wages climbed from just over 50% to 61.5% in 1974–1975. From 1983, however, this share steadily declined, reaching a low of 52.8% in 1988–1989 and remaining relatively stable ever since. At the same time, the profit share (in national income) has increased, rising strongly since the early 1990s.[30]

The Australian Accord proved critical to breaking the "boom-bust" cycle that had so often marred Australia's economic performance. Later versions of the agreement focused on increasing the flexibility of the labor market, replacing centralized wage-setting with industry and firm-level approaches. Australian solidarism, together with broader economic reforms (including fiscal consolidation, lower protection, financial market deregulation) over the 1980s and 1990s, set the scene for this country's impressive economic record in recent decades. In contrast to Sweden—where solidarism became entrenched—the Australian variant responded to varying economic challenges and was eventually largely phased out when its key "tasks" were fulfilled.

Lessons

High rates of capital accumulation can play an enabling role in a developmental strategy; they can facilitate an increase in the rate of investment, technological change and growth. But, in this chapter, I have argued that a strategy of enhanced mobilization can sharply increase the rate of capital accumulation by reducing the share of income that goes to wages. In choosing my case studies, I wanted to highlight examples of wages being successfully "adjusted downward" in relative terms in

[30] *Australian System of National Accounts (5204.0)* (Australian Bureau of Statistics, 2002–2003).

democratic, highly unionized economies. I did so in order to offer a useful counterpoint to the alternative strategy: forcing down wages by banning unions or by other repressive measures. I also distinguish these examples from free-market reforms and union busting, as in Britain, New Zealand, and the United States in the 1980s.

What lessons can we draw from our brief examination of wage restraint and/or solidarism? First, it is clear that centralized agreements must have broad support if they are to be sustained. It may not even be necessary to have a formal agreement.

Second, in each case, these agreements tilted the market frameworks for policy-based reasons to favor capital relative to labor, not to level an imaginary playing field. In each case we looked at, this meant lower wage growth (or outright wage reductions) in order to improve the profit share in national income. Other employer friendly changes, such as more flexible employment contracts (in the Netherlands) and greater management autonomy (Sweden) were also featured. By enhancing the returns to capital, negotiated wage restraint sought to establish a "high investment, high productivity" virtuous circle.

Third, in the Swedish case, solidarism across sectors added a second element to the mobilization strategy by favoring the high productivity and implicitly high-growth sectors. It shifted the wage curve away from a "pay for productivity" concept toward one of "equal pay for equal work." Thus solidarism implies a measure of targeting of the wage repression in favor of high-growth and high-productivity sectors. Arguably, this was the case in Sweden and probably also in Ireland.

Fourth, solidarism can be seen as an exercise in "social capital" building. By invoking concepts like "solidarity" and "the social contract," successful centralized agreements reassure unions that initial concessions will be repaid in higher wages and increased employment. For employers, they provide some insurance against opportunistic wage claims when labor markets tighten. By building trust and mutual confidence, and by ensuring the benefits of wage moderation are widely distributed, centralized agreements can win broad support for needed reforms with a minimum of confrontation or disruption. Adjustment costs are therefore minimized.

Fifth, the concept of wage restraint as an active way to enhance mobilization was not all that new for Europeans in the 1980s. As shown in Fig. 12.4, Denmark, France, Germany, and the Netherlands all had employee compensation rates below 50% of GDP in 1960, as they were still in recovery mode from World War II. Sweden, in contrast, was at 55%, and the United Kingdom and the United States were at almost 60%. While it was reasonable for the United States and Sweden to have higher shares going to wages, and thus less active resource mobilization because they had not been comparably damaged by the war, one could wonder if the British failed to notice how much they had been damaged and how badly they needed enhanced mobilization. This was arguably a fundamental source of low growth and a rapid decline of Britain's manufacturing sector. Britain fell woefully behind in capital invested per worker in its manufactures. Unfortunately, hostile labor relations in the United Kingdom prevented any such strategy until the late 1980s.

Sixth, it is worth emphasizing that the initial trigger for successful solidarism is usually an economic crisis or external threat. With a clear and present danger, business and labor groups are better able to recognize the interdependence of their interests. Governments, for their part, are more willing to spend political capital in brokering agreements. The challenge for the framers of centralized agreements is to adjust them in response to changing economic circumstances—moving, for example, from short-term wages moderation to fundamental labor market reform. When managed well, solidaristic agreements are a lever for change, not an impediment to it.

Seventh, the Swedish case is exceptional in having generated wage moderation for about 50 years before being overtaken by a policy reversal. In those 50 years, Sweden was a world leader in industrialization as well as in being an innovative welfare state. It provided remarkable job opportunities in some of the world's most innovative and admired manufacturing firms right along with its welfare state. The other countries noted here embarked on more modest programs, but in each case successfully.

Finally, a few words of caution are in order. Solidarism through industry-wide bargaining or even nationwide bargaining can also be a weakness. Sweden's experience in the 1970s demonstrates what can happen when solidarism is pursued in disregard of competitive realities, backed by the political power of a strong, left-leaning regime. In each of the case studies we examined, solidarism was accompanied by a range of supporting economic reforms, including sound macroeconomic policies, welfare reforms, and greater openness to trade. Absent these supportive reforms, it could have gone still further off the rails in the 1980s.

Solidarism was an appropriate response to the particular circumstances these countries faced and in keeping with their institutional traditions: all were relatively small or medium sized, relatively homogenous societies that were highly unionized and facing wage costs that were a high fraction of GDP relative to their competitors. These are not the circumstances faced by many developing economies. For them, low rates of investment and growth are due to other factors, e.g., dysfunctional institutions starting with poor quality public schools that have stunted the development of their labor force, the development of technological capabilities that would lead to successful patent applications, and the successful mobilization of domestic credit for the private sector. If solidarism offers a general lesson, it is in showing how credible, widely supported social agreements can smooth the path for difficult economic reforms. On the other hand, wage repression in an authoritarian context, without union support, invites a different response, as we will see below.

All of these examples illustrate what can be done to reshape market frameworks, in just the way suggested in Chap. 2, in order to promote medium-term performance through coordinated action. None are necessarily right for the long term. But these examples from democratic societies give us a base line from which to view situations in East Asia that are more like Sweden between 1905 and 1920 in terms of the perceived need to enhance the level of resource mobilization to deal with a difficult economic and political situation. In these East Asian cases, the enhanced mobilization was even more extensive than in Sweden, and it was backed by less than liberal regimes, Japan included.

East Asian Labor Policies and Financial Mobilization

How did East Asian labor market policies compare with these examples from high-income liberal democracies? The World Bank, in its report on The East Asian Miracle, credits the high performing East Asian countries with achieving "a relatively high level of efficiency in the allocation of labor ... by allowing wages and employment to be determined largely by the interaction of those supplying and those demanding labor services rather than by government legislation, public sector leadership, or union pressure."[31] In other words, The World Bank attributed the strong performance of East Asia to market forces that were relatively unimpeded by attempts at coordination. Implicitly, this was another triumph for the economic fundamentals of the Washington Consensus approach.

But in the same chapter of the same text, the Bank noted that market efficiency had been facilitated "By not allowing the price of labor in some sectors to earn well above what workers could earn elsewhere in the economy."[32] According to their analysis, one key to East Asian success was the elimination of economic rent from the wage bill. This approach to wage formation sounds remarkably like the policy prescription worked out by the Swedish employers early last century, where they too tried to eliminate economic rent from the wage structure.

How was it that East Asian workers that might have had an opportunity to achieve a measure of economic rent were "not allowed" to do so? The Bank went on to assure its readers that, except for Singapore, these countries did not follow policies of wage repression.[33] Did this mean that they had free markets? Yes, the workers were free to bargain for wages, but only as individuals and not collectively. The East Asian countries systematically and sometimes brutally repressed labor unions.[34] Wage moderation was aided by outlawing collective bargaining so that the markets were free to work with lopsided power in the hands of management. With such unilateral power, not many capitalists would need guidance from government on how to achieve wage moderation, even in markets characterized by fast growth in labor demand, as labor migrated from rural to urban areas early in the high-growth years. If current workers insisted on more money, they could be displaced by immigrants coming in from the fields, a parallel to the United States in the years 1840–1940. Once full employment was reached, on the other hand, these economies were characterized by unusually rapid increases in wages, in much the same pattern achieved in Sweden.

[31] The World Bank, *The East Asian Miracle*, 266.
[32] Ibid.
[33] Ibid., 271.
[34] Ibid.

The East Asian labor markets exhibited another parallel with the European examples given above. "Another notable feature of the structure of wages in East Asia . . . is the modest size of the gap between skilled and unskilled wages in the non-agricultural sector. The small gap did not result from minimum wage legislation pushing up unskilled wages. Rather the growth in demand for unskilled labor, in combination with a marked increase in the abundance of educated workers, compressed the occupational structure of wages."[35] In other words, with average wages at below market levels, there would sooner or later be a shortage of labor, and wages would rise in the low-skilled segments in much the same way that they had in Sweden, pressuring employers to move up market toward higher value-added activities or to exit from business altogether.

The East Asian story might be told rather differently if one wanted to acknowledge the role of strategy in relation to market forces. In this event, one would emphasize repression of unions as a way to achieve wage moderation, high profits, high rates of domestic saving, enhanced investment, productivity gains and rapid growth. Rapid growth would eventually lead to full employment and, eventually, a labor shortage with a compression of the wage structure that would help maintain their initially egalitarian income and wealth structures. At the same time, over-full employment would help draw more labor out of agriculture faster, thereby contributing to increased productivity and growth, i.e., a virtuous circle. And, as in the view of SAF, this would show the efficacy of a strategy of enhanced mobilization to raise profits, investments, the acquisition of new technologies, and additional competitiveness in the export of manufactures. Not having chosen that explanation, the Bank had no need to report on relative corporate profit levels or rates of return. Instead, it could talk about rapid accumulation, a result that was premised upon natural forces in the market place.

In East Asia, the strategy of enhanced mobilization through wage moderation and wage solidarity took place in the context and with the backing of one party, if not authoritarian, regimes in Korea, Singapore and Taiwan, and in the context of a one-party regime in Japan for most of its first 50 years of independence (i.e., 1953–2003). Malaysia got a later start in 1970, and China in 1978; the former had a three-party regime managed through a directorate controlled by one party (UNMO), and the latter had a one-party, authoritarian regime. The implicit wage repression involved in all of these cases might be unwelcome in most if not all multiparty democracies, but the East Asians succeeded in raising the living standards of their people in the postwar period faster than any other group of countries in history. Political support in the early years of their enhanced mobilization regimes stemmed in part from strong political leadership that focused on the need for high growth to permit these countries to achieve much higher incomes as an essential for political equality with the already rich countries. In addition, all had unusually egalitarian distributions of income and wealth when they launched their strategies, a factor that was assisted in Japan, Korea, and Taiwan by US postwar "guidance."

[35] Ibid., 267.

East Asia also Practiced Enhanced Financial Mobilization

"Enhanced financial mobilization" aims to make additional capital available for productive investment, at below market interest rates, and typically with tolerance for additional risk. Below market interest rates imply an excess of demand over supply as well as the presence of abnormal returns within the corporate system, so this strategy requires a number of interrelated forms of intervention in order to keep those above market returns, or economic rents, within the country concerned. These interventions require the creation and monitoring of a number of specific institutions, and thus bureaucratic competence and integrity, if they are to remain effective through time. For example, this strategy relies upon banks to make the capital available at below market rates, and upon some form of regulation of these banks to see that the bulk of the economic rent ends up with the firms and not the banks. It also relies on restricted entry into banking, to avoid dissipation of their rents in unnecessary competition. In addition, it depends crucially on the absence of a market for corporate control, so that foreigners cannot make hostile takeovers and capture the policy-based rents in the local operating firms.

Whereas capital markets (bonds and stocks) are favored by the Washington Consensus model for their liquidity, efficiency, and transparency, bank-based lending is favored in the EM model because the relationship between borrower and lender can take account of considerations other than price (e.g., interest rate) and risk (e.g., policy goals). Countries with state-owned banks do not need an elaborate system of controls on interest rates, as they can limit credit to consumers, mandate low interest rates on business loans, and absorb operating losses within the banks if they arise. In practice, Korea's state-owned banks supplemented domestic savings with offshore borrowing from official financial institutions, using the credit rating of the state as security and receiving what amounted to low interest foreign loans that could be re-lent to favored borrowers. Obviously, there are technical and/or business judgment problems in designating who should receive such favored loans. There is also the constant risk of politicization of the lending criteria and corruption of the system. These are serious risks indeed, but not without historical precedent. There were serious risks in attempting the large-scale public works in the United States in the 19th century, as in the cases of canals or railroads to be discussed in Chap. 13, but those risks, and the eventual waste and corruption associated with them, were accepted as a price worth paying. So it is important to note how the model works rather than banishing it as either nonexistent, as so often happens, as impossible to implement, which is simply false in a historical sense, or as too risky, as though developing countries should not be permitted some of the waste experienced by the United States when it was a developing country.

The fundamental premise of the EM strategy is that the so-called neutral market framework of neoclassical economics is not designed to promote the rapid growth needed for the convergence of developing countries toward the income levels of the rich countries. In that neoclassical or Washington Consensus model, independent actors, acting in their own self-interest, will achieve market equilibria through elimination of economic rent, except for a few policy-based exceptions, such as those temporarily conferred by patents or copyrights. The implicit premise behind this Consensus model is that of Adam Smith, to the effect that the financial mobilization that can be accomplished by a country is no more than can be accomplished by the sum of its individual economic actors. This was and is mistaken, as Alexander Hamilton saw so clearly more than 200 years ago. A government can mobilize savings through credit creation (i.e., issuance of government debt) and can back that debt by the coercive taxing powers of the state, a power not available to individual actors. It is easier to achieve consensus for such credit-based spending if it is for purposes of national defense or for financing previous war debts, as in Hamilton's case.

In the EM strategy, the market framework is deliberately designed to favor producers relative to consumers until such time as the enhanced mobilization has led to capital accumulation more or less on a par with the leading economies, thus yielding political as well as economic equality for the members of the formerly developing economy. As the invested capital per worker in the developing country begins to approach the levels existing in developed countries, it becomes a natural time to phase out such a strategy.

The financial side of the EM strategy can be elucidated by comparing it with the "Rapid Accumulation" model outlined by the World Bank to explain the high performance of a selected group of East Asian countries.[36] The Bank began its explanation of the Strategies of Rapid Accumulation by noting: "Accumulation of productive assets is the foundation of economic growth."[37] Accumulation is a passive concept, a process that denies any notion of strategy, which is active and purposeful. Not surprisingly, the Bank noted that the causes of much of the observed rapid accumulation were high GDP growth, which was, in turn, due to a variety of natural causes, including declining birth rates as education and living standards improved. This explanation hinges on rapid accumulation as the result of decision-making at the individual level, or perhaps the family level. This analysis of causation would seem to rely on market forces, with little or no financial strategy. I suggest that there is a crucial question of what, if anything, the East Asians did to induce more rapid accumulation, e.g., whether they tried to achieve enhanced mobilization or, in contrast, simply saved more as family size declined.

The similarities and differences between the EM model and that of Rapid Accumulation can be seen most easily through a direct comparison of the policy choices and institutions associated with each (Table 12.2). However, it is important to recognize that they start from different goals and premises that are not explicitly noted in the World Bank presentation of its Functional Approach to Growth.[38] In its explanation of how the Rapid Accumulation model works, the Bank makes clear that the big effects are from the policy fundamentals; there is little hint of anything as

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[36] Cf. "Strategies for Rapid Accumulation," in The World Bank, *The East Asian Miracle*; *The East Asian Miracle*, 83.

[37] The World Bank, *The East Asian Miracle*, 191.

[38] Ibid., 88.

bold as enhanced mobilization, and the distinctive selective interventions are noted as controversial, but impossible to evaluate for sure. Thus there is no unequivocal notion that policy intervention was positive, though that possibility is not totally ruled out.

According to the Bank, "The broadest interventions were generous incentives for manufactures."[39] These interventions are easily seen in their scheme of directed credit for an export push. Financial repression means paying below market interest rates for deposits, creating the possibility for below market rates on loans, with the consumer-saver picking up the cost rather than government. And yet this connection is not explicitly made, either for Japan, where the system of interest rate repression was comprehensive, or for Korea, where it was less so but perhaps more selective in terms of the type of firm and the degree of subsidization. The failure to make such connections seems surprising to say the least, given their potential significance to an activist strategy, whether well implemented or not.

As we noted above, aside from acknowledging small gains in the saving rate, based upon forced saving in Singapore, the authors of the World Bank report are at pains to explain that the East Asian saving and investment rates have not been greatly affected by policy, even if the policies are not clearly explained yet regarded as highly controversial. Selective policies may help reallocate activity, for example, toward manufactures relative to agriculture or services, but these policies create market distortions and are seen as controversial and unproven. While market distortions imply the existence, if not creation, of economic rent, there is no analysis of corporate profitability that might suggest the presence or absence of such rent, and no analyses of balance sheet leverage to indicate whether the high growth had been facilitated by abnormal leverage. The presence of abnormal leverage would suggest the presence of abnormal risks that have been assumed by the banks in the first instance, and thence by an implicit guarantee by government, which means ultimately by the taxpayer, e.g., in Japan and Korea.

Japan as a Case Study in Broad-Based Mobilization

Japan in the 1960s and 1970s can serve as an illustration of how there could be enhanced mobilization of financial resources (i.e., high saving and investment) at the same time that there were repressed interest rates. The goal of enhanced financial mobilization is to create a large pool of savings at low if not negative real interest rates, so that these funds could be re-lent to corporate borrowers at below market rates. At the time (the 1960s), Japanese banks provided more than 40% of the net financing of Japan's non-financial firms.[40] In order for this to work in an economy growing at a compound rate in excess of 10% per year, Japan's pool of savings had to grow even faster. In the event, they grew from almost 28% of disposable

[39] Ibid., 89.

[40] The World Bank, *The East Asian Miracle*, 225, Table 5.8.

income in 1960 to 34% by 1971, while Japanese investment grew from about 22% of GDP in 1955 to about 40% of GDP in 1971, meaning that they more than tripled in real terms in a decade.[41] By comparison, US saving declined slightly from 9% of disposable income in 1960 to 8% in 1971, and investment was almost unchanged for the period 1960–1971 at 17% of GDP, meaning that saving had grown even less than GDP over the decade.

Whereas some of Japan's high saving was due to rapid economic growth, including the spread of two-income families in rural areas, and thus fits the notion of rapid accumulation, some was instead induced by forced saving, for example, high down payments on home mortgages.[42] Paradoxically, Japan had the highest rate of saving among the major industrial countries after World War II and, at the same time, negative real interest rates. On average, Japan had a negative real rate of interest of 1.12% for 38 years, from 1953 until 1991. This compares with a positive interest rate of 2.22% for the United States from 1965 to 1991, and generally positive interest rates in the other high-growth East Asian countries.[43]

Some of the key aspects of the Japanese system were created by the US Occupation authorities, but for utterly different purposes, i.e., to control inflation. Thus, as remedy to a 1949 inflationary crisis in Japan, the US authorities imposed a Temporary Interest Rate Law (TIRAL) upon Japan, a regime that lasted almost 40 years.[44] The law set maximum rates on deposits and loans, short term as well as long term. With this regime, the Bank of Japan could set deposit rates at below market levels, and likewise lending rates, thus forcing the banks to pass their low cost funds on to their borrowers at below market rates, as suggested in Fig. 12.7.

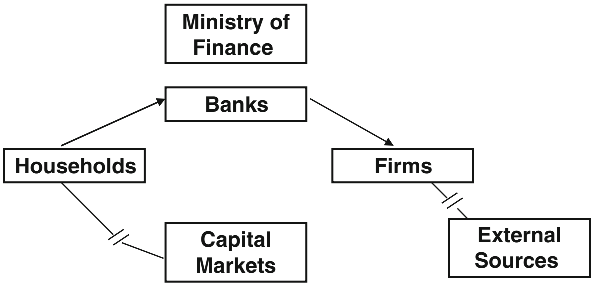

Fig. 12.7 Schematic diagram of Japanese financial system. Source: Bruce R. Scott

[41] Bruce R. Scott, John W. Rosenblum, and Audrey T. Sproat, *Case Studies in Political Economy: Japan, 1854–1977* (Boston: Harvard Business School Press, 1980).

[42] See, for example, Miyohei Shinohara, *Growth and cycles in the Japanese economy*, Economic research series (Hitotsubashi Daigaku. Keizai Kenkyujo) 5 (Tokyo: Kinokuniya Bookstore, 1962).

[43] The World Bank, *The East Asian Miracle*, 206, Table 5.5.

[44] Ulrike Schaede, "Japanese Financial System: From Postwar to the New Millennium," Harvard Business School Case No. 700-049.

Even with low interest rates on deposits, the Japanese had an incentive to save because of the high down payment requirements for home mortgages, often 40%. But they had other reasons to save as well: incomes were initially very low but steadily rising, so it was easier to save than if incomes had been stagnant. In addition, after losing a war, there was a patriotic opportunity to help finance reconstruction and then the rapid growth era. Savers had little choice. The Japanese government all but emasculated the domestic capital markets by establishing collateral requirements for the issuance of bonds. The cost of the collateral raised the cost of bonds and effectively made them noncompetitive with loans. Households had no good alternative outlet for their savings other than banks, and firms had no good alternative sources to internal cash flow other than the banks. And the banks were not interested in consumer lending, so long as rates were controlled.

This system worked just fine until about 1975, when the Japanese government began to run fiscal deficits to offset a slowdown in economic growth. Once the government started running deficits, it had to borrow; hence it had to be willing to see the capital markets revived. Thus, this was a system where a very high-growth rate was financed almost entirely from domestic savings, and some fraction of the saving was forced. The Japanese postal savings system was more of the same. The Japanese could deposit their money in a safe institution, guaranteed by government, and receive interest at a convenient location. Meanwhile, the Japanese government could use these low cost funds to supplement capital made available by the banks, to preferred borrowers

With a below-market rate of interest, this system created unusual demand for credit, effectively empowering the major banks to ration funds among their borrowers. And Japanese firms, like their Korean counterparts, took advantage of these favorable circumstances to run up extraordinary financial leverage for their firms. With leverage of six to one, the banks were accepting unusual risks that were backed by implicit guarantees from the Ministry of Finance in case of crisis.[45] This shifted the credit risk to the Ministry and, in reality, to the taxpayer. But this risk was borne lightly.

Since rates were controlled, this discouraged small-scale loans in favor of large loans to corporate clients, virtually eliminating consumer lending at the major banks. As time went on, a new class of institutions, like the US savings and loans institutions, were established to meet consumer needs, and, later still, commercial banks would find that they had a surplus of funds with which to enter consumer lending. But credit rationing did give banks the power to impose implicit rate increases through demands for compensating balances as conditions for loans. Needless to say, it also gave the banks incentives to expand their loan volumes, even at added risk, because volume was the key to profits in a price-controlled market. The banks would suffer later, as the economy slowed down, because they had never developed much by way of skills in credit analysis. The slowdown also reduced demand for external funding, and Japanese manufacturing firms reduced their leverage from six

[45] Ibid.

to one as recently as 1980, to about three to one in the 1990s compared to about one to one for their counterparts in the United States.

The Japanese used this system of rationing low cost credit not only to finance business in general, but also to target lending among industries. The sectoral targeting was coordinated through the Ministry of International Trade and Industry (MITI) on the business side and the Ministry of Finance on overall credit availability. But a distinctive feature of the Japanese system was the repression of average lending rates, more than special deals for special borrowers. Nevertheless, the banks and thus the coordinating ministries had great power during the high-growth years because there was excess demand for funds; they could "just say no" to loan requests by firms and the same for back-up financing for the banks. With this implicit rationing scheme, the coordinating agencies could exercise power through what was known as "administrative guidance." This guidance had no statutory backing, but if borrowers failed to follow the guidance, they could expect more restricted access to funds in the future. Banks that failed to heed the guidance could also expect restrictions on their authority to open new branches or launch new products.

This was a system with great power, thanks to unusual leverage implicitly underwritten by the taxpayer. While a foreigner might wonder how a bureaucrat could exercise power that had no statutory basis, repressed interest rates created a shortage that gave power to those who did the rationing, and ultimately to the Ministry of Finance. And the power of the MOF was greatly enhanced by the fact that Japanese firms had little or no access to the courts for redress against any abuses. A continuing shortage of lawyers and judges meant that most cases could be expected to continue indefinitely, without satisfaction to the plaintiff. In practice, this meant that Japanese officials could wield preferential influence for or against individual firms, even if not necessarily offering them a preferential rate.[46]

Credit rationing created a desire by Japanese firms for additional, market-based financial sources, even if these sources might be somewhat more expensive. Anticipating this demand, the Japanese passed regulations requiring that all bonds be backed by collateral, thereby enhancing their implicit interest cost. As a result, bonds were a more expensive source of capital than bank loans, and bonds accounted for only about 5% of corporate financing from 1965 until 1975, compared to more than 20% from trade payables and about 40% from bank loans.[47] In addition, Japan had no open market for short-term commercial paper as recently as 1980,[48] and Japanese authorities had strict controls on foreign borrowing. However, large firms with foreign subsidiaries could circumvent the system by borrowing in offshore markets, e.g., foreign banks or the Euro–yen market.

[46] Katharina Pistor and Philip A. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development, 1960–1995* (Asian Development Bank and Oxford University Press, 1998).

[47] Ibid., 27, exhibit 12.

[48] Ibid., 25, exhibit 14.

Japan's bank-based system of channeling low priced funds to preferred borrowers began to breakdown in the mid-1970s, when the Japanese government started borrowing in the bond market to offset its budget deficits. As the government began to place bonds in the domestic market, firms and households began to have a more attractive outlet for their savings. In addition, there was a growing demand to reduce the discrimination against private-sector bonds. Once this process was underway, it was not long before there was a commercial paper market and thus additional choices for savers as well as sources for borrowers. This situation created an array of opportunities for arbitrage, or zaitec, as it was called. However, the real problems came with Japan's credit expansion to offset the threatened economic slowdown with the rise of the yen, following the Plaza Accord. The credit expansion helped sustain economic growth, but through creation of an unsustainable credit bubble. When the bubble burst in 1990, Japan experienced a decade of stagnation, that threatened to go on much longer still, and the problems facing borrowers, lenders, and government authorities changed quite radically. Unfortunately, the Japanese were not able to change their system as needed to meet the new circumstances, and their difficulties were ultimately political more than strictly economic.

In the post-bubble context, Japanese firms had much less need of funds for investment, and these needs could be more than covered by internal cash flow. Given the adequacy of internal corporate cash flows, the Japanese authorities had little leverage either with the firms or the banks. At the same time, the problems facing the firms had changed dramatically. Instead of needing funds to invest and grow, they needed to restructure, downsize and, in the extreme, exit some lines of business in order to boost profitability, and their system was ill suited to meet such a situation. With no market for corporate control, there could be no hostile takeovers to force change. It was up to the firms to become more profit-oriented, to avoid bankruptcy in the extreme, and to improve very weak returns at a minimum. And the same was true for the banks. Instead, both tried to procrastinate, and "new bad loans" became a key growth activity for the banks. Before the decade was over, the write offs were in the hundreds of billions of dollars and thus far larger relative to the Japanese economy than the savings and loan crisis in the United States, but a forewarning of what might happen in the United States when the Federal Reserve engineered unusually low rates to promote growth after the bursting of the technology bubble in 2000.

While one could say that there were indeed far-reaching problems in the Japanese financial system from 1990 onward, the technical or financial problems paled next to the lack of accountability of the Ministry of Finance. Although part of an elected government, the ministry constituted the center of power of the regime, with self-selection of all but a handful of posts at the top, and control over the budget, treasury, tax authorities, central bank, bank regulators, and the staff that prepared all budgetary legislation. A new Prime Minister could only make 25 or 30 appointments, compared to almost 4000 for a new American president. In addition, Japan continued to be governed by something close to a one-party political system. There was no voting out the old regime in favor of a new, and no real housecleaning. Thus, a system that had mobilized and harnessed a huge amount of power for three decades after independence was unable to adjust to the changed circumstances after 1990.

For a system of enhanced financial mobilization to work, domestic firms need to be protected from hostile foreign takeover. This was not an issue for the Singaporeans, as most of their large firms were foreign to begin with. But for the other East Asian high-growth countries, it required some form of institutional obstruction to hostile takeovers, and especially to foreign takeovers. Otherwise, the abnormal access to profits and leverage would become targets for foreign investors. Japan insulated its firms from this risk by a gradual process of institutionalization of large blocks of shares in all major firms. Ownership came to reside in cross-holdings in so-called horizontal kiretsu, typically centered on a bank but also involving insurance companies. While shares traded freely on the Tokyo exchange, most large Japanese firms had controlling blocks of securities in friendly hands, i.e., not on the market. As an indication of how this worked, Japan had no hostile takeovers in the postwar era and virtually no foreign takeovers until the prolonged recession of the 1990s, when the authorities were prepared to see foreigners take over distressed firms on condition that the buyer inject new capital as well as management personnel. Korea blocked foreign takeovers until the financial crisis of 1997, at which point the IMF demanded an end to such controls as a condition for its support in solving a short-term liquidity problem, a form of pressure that has created anti-Western and especially anti-US animus in Korea.

Risks in These Financial Systems

As the old saying goes, there is no free lunch. The enhanced systems of financial mobilization, other than that of Singapore, entailed higher risks. And in each of these systems, e.g., Japan, Korea, and Taiwan, that risk was initially borne by the state and, in reality, by the taxpayer. Whereas banks were expected to know their clients very well, there was little or no premium for additional risk and thus little to be gained by sophisticated risk analysis. The profits were seen as based on loan volume. In addition, at least in Japan, senior managers would describe the internal culture of the major banks as one reluctant to assign responsibility for loan performance to particular individuals, such as the individuals who had championed the loan in the first place. The system depended upon surveillance by the public authorities in the Ministry of Finance. But so long as there was high growth, the authorities had very considerable leverage with respect to both the banks and the firms through their powers to ration credit. And, at the same time, there was little incentive to intervene to discipline lenders for excessive risk-taking. With high growth, chances are that further growth would eventually permit recuperation of the loan.

Some of the risks in the system showed up in the unusual leverage employed by non-financial firms and allowed by their banks. Thus in Japan it was not uncommon for manufacturing firms to run debts at five times equity in the 1980s, and at six times equity in non-financial firms. Much the same was true in Korea for the Chaebols. In both cases, the assumptions were that large firms were too large to fail and that, in the end, the ministry of finance and thus the taxpayer stood behind the unusual leverage. This was one thing when there was rapid economic growth; excessive lending could be corrected by pulling back for a time, while economic growth provided the needed cash flow to pay down some of the debt. But this would not work as growth slowed, much less in the Japanese stagnation of the 1990s. In the context of economic stagnation, bad loans required refinancing and indeed new money to keep the companies afloat. In such a context, "new bad loans" became a growth sector, and the banks piled up hundreds of billions of dollars of bad loans, in amounts still to be fully determined.

In addition, the client base of the banks changed radically, also increasing their risks and doing so in ways that they were ill prepared to deal with. Successful large firms continued to generate cash flow in the slowdown, and cash flow came to finance all or nearly all of their needs. As a result, large firms and often the best credit risks became less and less dependent on external sources of funds, so the banks had to search out smaller clients with potentially greater risks to be dealt with by personnel who had little experience in credit analysis. The problem for the Japanese banks was not just financial; it entailed retraining thousands of people while also creating governance structures that assigned and monitored credit responsibility from within. Officials in Japan's Ministry of Finance have no particular claim to skills when it comes to forcing firms to exit an industry or even to restructuring, and they are likely to be under political pressures to delay rather than accelerate such processes for political reasons. Much the same can be said of their counterparts in Korea, as they also faced the need to deal with deteriorating balance sheets among the Chaebol. In both cases, the discipline of bankruptcy was much needed and much delayed. And one can also argue that more disciplined corporate governance was also needed, perhaps prodded by a market for corporate control. Instead, low-cost loans kept zombie companies alive, and the low prices, low-margin activities of the latter delayed the recovery of the still healthy companies.[49]

Japanese banks have written off hundreds of billions in bad loans since the early 1990s, with a considerable fraction reimbursed by government. External estimates indicate that the total involved may have come to one trillion dollars or more, without counting the problems in the insurance companies. These amounts are very large. Since the Japanese economy is about half the size of its US counterpart, if adjusted for relative population the total might be as much as two trillion dollars, versus the 150 billion cost of the US bailout of the saving and loan institutions. However, the US financial crisis may well cost the banks and the Treasury two trillion dollars as well. But whatever the bad loan cost may have been, it understates the full cost. Failure to develop credit analysis skills meant that much capital was poorly used if not lost. Japan was investing about 25% of GDP to grow about 1% per year in the 1990s in real terms, or achieving an incremental output to capital ratio of about 4% per year. This looks dramatically different from the 1960s, when investment approximated about 33% of GDP and growth about 10%, for an incremental

[49] See Schaede, "The Japanese Financial System."

output to capital investment ratio of about 30%. US figures would lie between these two extremes, with investment of about 16% of GDP in the 1990s associated with growth of about 3.5–4% per year, for an incremental return in the 20–25% range.[50]

Conclusions

The EM strategy has been applied successfully in developed as well as developing countries, with Sweden in the period 1905–1960 as an early exemplar. It has only been successfully applied in circumstances where a country faces a very severe challenge, where there is broad collective support for a strategy that requires current sacrifices for future gains, and where the distribution of income and/or wealth is relatively egalitarian. This relatively egalitarian distribution of wealth helped create a sense of trust that any sacrifice would also be shared. The inter-temporal problem, of short-term costs for longer term gains, seems most likely to achieve public acceptance when property and incomes are distributed relatively equally and the public is well educated. It can be successfully implemented either in a democratic context with consensual decision-making among business and labor and government, as in Sweden, the Netherlands, Ireland, and Australia, or through a strong state with the power to repress labor unions and to control access to credit, as in the East Asian examples. The latter uses of state power also seem to require a national emergency and/or consensus on the need to catch up, in order to justify collective action is the public interest. Paradoxically, success will eventually cause the consensus on the need for catch up to dissipate, thereby depriving participants of their rationale for collective sacrifice. By the same token, these new and improved circumstances will reduce the public shame for abuse of trust and corruption. Even a highly competent civil service, as in Japan in the 1970s and early 1980s, can succumb to gross mismanagement. Despite some of these later failures, overall it seems to me that most of the sustained high-growth strategies of the post-World War II era have been of the Enhanced Mobilization sort, and a source of remarkable success for decades at a time.

But EM is a strategy fraught with risk as well as promise. As a country catches up with the leaders, its economy will almost inevitably become more diversified, and its needs for increased search activities for further diversification will be better served by more decentralized decision-making processes, e.g., by firms in markets. As this happens, it needs to adjust the orientation of its institutions from the producer focus to one more oriented to its consumers. EM approaches that fail to do this can become economically dysfunctional, as happened in Japan beginning in the mid-1980s. As the financial crisis that began in 2007 currently unfolds in the United States and Europe, both may find that they have been caught with financial bubbles like Japan in the 1990s and, whereas it was initially thought that it took Japan the decade of the 1990s to work off the excess leverage, hindsight may suggest that this process

[50] Ibid., footnote 50.

took at least twice that long. Luckily, some of the other Asian countries that made use of high leverage, e.g., Taiwan, have not (yet) been as significantly affected. The enhanced mobilization strategy has its risks, and financing it with unusual levels of debt may be more risky than was recognized at the time.

Part V
The Evolution of US Capitalism and Democracy, 1830–2009

Prologue
Transformations in the Governance of US Capitalism and Democracy

If one flies over the Eastern United States on a clear day, and looks down on either side of the plane, one can still make out the squares of a giant grid that dates from the Northwest Ordinance of 1785–1787. This ordinance, which was established by the Continental Congress, was designed to decentralize power to state and local governments by splitting the country into a considerable number of states, with provision for more, while creating an initial "subdivision of 400,000 square miles comprised of Ohio, Indiana, Illinois, Michigan and Wisconsin." These states, and a portion of Minnesota, were to be subdivided into small parcels of land of 640 acres, or one square mile each, with provision for further subdivision into parcels of 160 acres, 80 acres, and even 40 acres, all to be surveyed and then sold for cash, to try to achieve diversified land ownership. It was a pattern that would be extended westward to the Rocky Mountains. In this framework, the township, with approximately 36 square miles of land, became the basic unit of local governance, and 1 square mile in each township was reserved to provide tax income for a school system. What was initially almost entirely federal land became state land when purchased by private users, meaning that real estate tax proceeds went to the state governments rather than the federal government. This division of land and tax revenues split the United States into small plots to be governed by many small communities, with much of the power administered by cities and towns, which were virtually independent of either state or federal oversight. Contrary to the French structure described by de Tocqueville, there were no federally appointed magistrates to supervise either the state or the local governments.

The vast expanse of US land was primarily comprised of good to excellent land, most of it suitable for rain-fed agriculture. This meant that there was little need for collective action in the management of the land, unlike in the Netherlands, where half of the land lies below sea level, or Egypt, where the water from the Nile is vital to farming. Into this vast expanse, Europeans immigrants arrived to start farms and small businesses, typically with only one employee or one family. Even in 1830 ten employees was a big firm. And with horse-drawn vehicles as the main means of transport, a trading radius of 10 miles was considerable except along navigable waterways such as the Great Lakes, the Ohio-Mississippi River system, or, later the Erie Canal.

Thus, for its first 200 years of existence—first as colonies and then as a single nation, circa 1630–1830—the United States enjoyed a remarkable symbiosis between its atomistic form of capitalism, where its markets and firms were small; its technologies relatively simple; and its government, though nominally powerful, was in reality undersized, decentralized, and weak by design. There was little need for great public works except for the early canals, where a federal role was rejected, and for a financial system, where a federal banking system was twice created and then forced out of operation as an unwarranted concentration of power. The eventual emergence of a Federal Reserve System was delayed by more than 200 years after the founding of the Bank of England, and only proposed and acted upon after a panic almost destroyed the money-based economy in the Panic of 1907. The post office was perhaps the leading example of federal ownership, followed more than a century later by the Panama Canal.

Over the next 180 years, 1830–2010, this picture of productive units that were small and without market power would change radically. US entrepreneurs would spawn firms that would grow to become some of the largest centers of private power the world had ever seen. And, as time passed, these economic giants would bid for political power. Large private firms were able to challenge and even overwhelm state governments and local governments, and, in so doing, to reduce or eliminate their payment of taxes or their obedience to local regulations. As they did so, firms were in fact subverting democracy, as the capitalist system had the capacity to overwhelm and capture the democratic aspect of the political system.

The rationale for powerful industrial firms lay in their increasing economies of scale and speed, owed largely to the new technologies based on inanimate forms of power, i.e., water then steam and then electricity. Increasing economies of scale and speed implied that size itself was indispensible to maximum economic growth. Size was also a key to economic and political power—and to corruption of the system for private benefit. How was a new country that was in the process of settling and developing a continent to manage the tradeoff between increased size and power for its firms to promote economic growth, and the need for increased regulatory power to preserve democratic governance? What economic theories existed to guide policymakers on appropriate scale and efficient forms of organization? What roles were to be played by state governments, the Congress, the Federal Courts, and the Executive Branch? In addition to operating any regulatory authorities, who or what agencies were to take responsibility for thinking about the power structure of the new country and for seeing it implemented?

The federal structure embodied in the Constitution, coupled with a public mistrust of centralized power inherited from the early tensions with the mother country, combined to induce the creation of a distinctive set of institutions for US capitalism, indeed a set quite unlike those in any other country. Of these institutions of capitalism, perhaps the division of powers among the three levels of government when it came to the chartering and regulation of firms is the most important for this book. As pointed out in Chap. 7, the federal government had no recognized powers to charter firms, so this power was left to the several states. This meant that the states could compete with each other for the fees and other benefits that went with the issuance of corporate charters, including the increased employment and revenues that might flow to the state that granted such a charter. With 13 initial sources for corporate charters growing to 50, there was obviously competition for laxity in terms of regulatory requirements, and it was not long before the original terms for granting such powers had been watered down to require little more than payment of a standard fee. This gave the United States a uniquely permissive context for chartering.

When it came to regulation of the activities of an existing firm, each state could control firms within its borders but not beyond. The federal government was left with responsibility for regulating the continental market, but with a tiny government, no provision for the establishment of a trained civil service, and almost no criteria for guidance when it came to the purposes of the rules. While not enumerated in the Constitution, the case of *Marbury v Madison* (1803) implicity gave the Supreme Court the right to review Acts of Congress for their compatibility with the Constitution. This power to declare a Federal law unconstitutional was used only twice during the first 70 years of the new nation's history (1790–1860), but 58 times during the second 70 years, and then like an artillery barrage during the early 1930s, to strike down some of the key pillars of Franklin Roosevelt's New Deal. In a pivotal case, *Lochner v. New York* (1905), the Court, citing due process, overturned a statute passed by the State of New York, as affirmed by the Supreme Court of New York State that limited the hours a baker in New York might work to 10 per day. Declaring that the legislation infringed on the rights of an employer and its employees to bargain freely to reach a contract to work more than a 60-h week, the Court ruled the statute unconstitutional. In his dissent, Justice Oliver Wendell Holmes, Jr. raised an issue of signal importance to the US capitalist model, writing: "a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen to the State or of *laissez-faire*. . . . the accident of our finding certain opinions natural and familiar, or novel, and even shocking ought not to conclude our judgment upon the question whether statutes embodying them conflict with the Constitution of the United States."[1]

Much of the distinctiveness of the US capitalist model hinges on the unique form of competition among state governments as chartering authorities and the race to the bottom in regulatory laxity that it induced. However, this competitive dynamic was supplemented during the years after the Civil War by a Supreme Court inclined to dismiss as unconstitutional those laws inconsistent with laissez-faire capitalism. In 1937, the Court's tendency of deciding against regulation, in favor of business, was challenged in a confrontation over President Roosevelt's proposal to add new

[1] *Lochner v. New York,* 198 U.S. 45 (1905).

members to the Court (i.e., to pack it). Taken together, the effect of competitive state chartering and the Supreme Court's opposition to laws restricting the applicability of the laissez-faire doctrine gave US capitalism its distinctive characteristic of welcoming creative destruction, or the management of firms in the interests of shareholders relative to other potential claimants on its resources, such as consumers, employees, or communities. The confrontation was finessed, without any long-term settlement, but with a change in the membership of the Court, and hence its decisions.

The period 1937–1980 gave the US exposure to a social democratic model of capitalism, much like the industrial democracies of Western Europe plus Australia and New Zealand, after which deregulation would return it to a more traditional laissez-faire model. And it would not be long before an economic oligarchy once again amassed enough power to bring about a transformation of US democracy into a form that would promote the economic interests of a small elite. However, in this second experience of promoting laissez-faire capitalism, the shift in the balance of power was not due to the firms becoming large relative to government; instead it was induced by a loss of governmental power relative to the firms, thanks in large measure to the deregulation of democracy itself. This raised a genuinely new question. If democratic government had experienced a decline in its powers despite being housed in the most powerful country in the world, how had it happened, and what did it imply about the potential of the United States to modernize its institutions of capitalism and/or democracy? A broader problem also presented itself: How would any such loss in relative power of government affect the US power and/or purpose to lead an international alliance? Indeed, it was questionable whether the democratic and capitalist systems in place in the United States were still viable models for the international community, and whether, further, this uncertainty could be acknowledged, evaluated, or debated in the United States.

Chapter 13
The Transformation of US Capitalism and Democracy, 1830–1937

Co-authored by Linnea N. Meyer

This chapter examines the transformation of capitalism and democracy in the United States during a period in which private economic power rose to overwhelm the forces of democracy, until a political–constitutional showdown curtailed its ascendency. While the new technologies of the Industrial Revolution were immediately associated with the increase in private economic power, the legal empowerment of firms also played a major role in the development of US capitalism during this period, and perhaps almost as important a role in promoting the long-term development of the nation. This chapter will treat the Industrial Revolution as contextual background that helped induce, but by no means fully determine, system-wide changes. Important as the technological innovations were, they did not decide the nature of the institutional changes that would reshape capitalism or the economy in the United States or, indeed, in other countries.

The case of the transformation of US capitalism in the 19th century is a particularly propitious one through which to illustrate the remarkable impact of human agency on economic development. The US economic system began this period with no large or even medium-sized firms, but ended it with a number of firms that were among the largest the world had ever known. Firms grew from no more than 100 employees to over 100,000; in so doing they represented—in terms of employment, revenue, profit, and, less quantifiably, political influence—concentrations of power that were as large if not larger than any that had ever been managed by private parties.[1]

The huge increases in private economic power to be found in US firms are usually attributed to the increased productivity of firms,[2] and particularly to the increasing economies of scale and scope that flowed from the new technologies of the Industrial

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[1]The British East India Company and the Dutch East India Company would be arguable exceptions, but both were organized to operate in colonial territories, and were eventually transformed into quasi-official entities for the exploitation of conquered peoples.

[2]These changes in the strategies and structures of the leading firms of the era are documented in Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge: The Belknap Press of Harvard University Press, 1977).

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_13,

Revolution as applied to the increasing market opportunities of a growing continental market. To the extent that the US economy was propelled by the creation and adoption of new forms of organization that permitted the management of a series of vertically integrated steps within the firm, firms' empowerment was based upon a partial escape from market forces, especially when new technologies afforded periods of temporary market dominance for the new firms. And, to whatever extent it might be based upon conferring additional power upon those firms through their charters of incorporation or through reducing their responsibilities to society for the receipt of such charters, one can speak of a deliberate transfer of power from product markets and consumers to factor markets and producers. Such changes were not without political implications.

Indeed, the growth of firms was enabled by political actions, which shaped the capitalist system and the legal framework in which firms flourished. Changes in the US capitalist system during these years facilitated a dramatic rise in the level of resource mobilization, for example, by inducing additional commitments of capital for industrial investment. If new technologies and markets opened increased economic opportunities, the creation and granting of corporate charters of indefinite duration tended to make such productive investment more secure and therefore more attractive, as did the authorization of corporate charters which provided for the indefinite lockup of investor capital at the discretion of the board of directors.

Subsequently, the authorization for the firms to create holding companies to hold and vote shares across state lines paved the way for industrial concentration, the creation of quasi-monopolies, and the creation of giant firms that reshaped US capitalism at a single stroke. This legislation, which had a national effect on the capitalist system, was passed by a state legislature in the face of its fiscal difficulties, yet not responded to by the US Congress. Since the Constitution did not empower Congress to grant corporate charters, it was state governments that were instrumental in empowering the giants who would come to exercise inordinate power both in the economy and in the political system.

The changes in US capitalist institutions reflected the often uncoordinated initiatives of states in responding to extraordinary developmental opportunities and evolving societal priorities as well as the new technologies in a context where there was a continuing mistrust of the role of federal power. Americans, hurrying to settle and develop their lightly populated country, turned to the private sector because it promised more rapid action than government entities; in addition they had continuing reservations about the role of state power in the economy. US acceptance of a predominant role for the private sector rendered it quite distinct from any European or South American variety of capitalism in the same period. Institutional innovations were initiated through the ad hoc decisions of legislatures, regulators, and courts of a governance system that had little capacity to coordinate among the various levels and subsystems of government. Indeed, competition among states to attract business investment undermined standards of public accountability for private actors. While states' independent and competitive courting of business diluted any national attempt at accountability, the absence of a federal banking system after the collapse of the Second National Bank left the United States without a national payment system or the ability to implement stabilizing monetary policy, issues corrected with the passage of the Federal Reserve Act in 1913, which established what amounted to a central bank.

As the economy grew more powerful by the end of the 19th century, large private firms effectively enjoyed the powers of oligarchy, while the powers of government lagged. Attempts by the states and the federal government to redress this imbalance were thwarted first by business lobbying and ultimately by the Supreme Court, which held as unconstitutional both state and federal laws which were found inconsistent with laissez-faire capitalism. Following the landslide electoral victory of Franklin Roosevelt and the Democratic Party in 1936, President Roosevelt was able to achieve a de facto majority on the Supreme Court. The new majority on the Court curtailed its tendency to "legislate," or at least to interpret the Constitution strongly in favor of the laissez-faire model and reestablished the legislatures, and notably the Congress, as the deciding voice on the US capitalist framework.

The Industrial Revolution, with its development of the new power-driven technologies and consequentially larger firms, is sometimes used to date the beginnings of capitalism, as though capitalism were a system that could be described by the activities of firms in markets. This book distinguishes 19th-century US capitalism from the technological and economic processes encouraged by the Industrial Revolution, defining the former as a system of governance whose purview included the institutions that shaped the markets as well as the political and regulatory authorities that decided on the shape of the markets and monitored competition. Capitalism was (and is) a system capable of providing simultaneous governance for two dramatically different productive systems existing at the same time and in the same localities, one atomistic and traditional and the other comprised of the emerging giants, and many new entities of intermediate scale as well. However, unlike the Industrial Revolution, capitalism was created more by political than economic actors. Unlike product markets, factor markets could not simply emerge spontaneously as conditions changed. Their emergence depended upon human agency, e.g., on institutional innovations that were partly regulatory and partly political in nature. Why should this distinction matter?

As suggested throughout this book, an account of new technologies inducing increasing economies of scale in production and marketing is essentially a one-level account of an economic transformation. While it can tell us a great deal about what happened in the US economy and why, it would be largely or even entirely an account that was confined to the study of changes as seen through the actions of firms in markets, without regard for changes in the institutional and, ultimately, the political system governing those markets. When it comes to interpreting the transformation brought about by the Industrial Revolution in the United States, we need to see *three* levels: markets, institutions, and political authorities. Moreover, we need to examine how changes, i.e., human decisions, at the second and third levels influenced the first, as well as the degree to which the Industrial Revolution was able to change the first and second levels in terms of the size and location of firms and the relative incomes among interests groups, and thus relative power relationships in US society, for instance, urban versus rural.

In the case of the 19th-century United States, all three levels of its capitalist system had been created and brought into operation more than a century before the advent of the Industrial Revolution and almost two centuries before the events discussed in this chapter. Within this system, there were three different levels of political governance—federal, state, and local—and three legitimate branches of government at each level. This history proves to be significant in that, paradoxically, the issue of governing the incipient giants of the new, dual economy fell to the local governments, the smallest and arguably weakest of the three levels. As US capitalism emerged during the 19th century, the governance system that had been in place faced an existential challenge, where some of the private actors were far more powerful than many units of government. This challenge, which implied an ongoing contest for political power as well as economic progress, could hardly have been anticipated when the governance system was emerging prior to 1830 and still less in 1787 when the United States was still a developing country with a largely agricultural economy. Few historical precedents were available to guide the establishment of a governance system for an incipient Industrial Revolution besides those inherited from Britain, i.e., a decentralized economic model and a centralized—and by some accounts, "tyrannical"—political model. It was only natural for US leaders to trust their economic institutions much more than their counterparts in almost any other country.

The mismatch between a growing and increasingly industrial US economy and its system of governance emerged midway through the 19th century. By 1830 US capitalism had already enjoyed almost 200 years of successful development in an era when the relationship between the economy and the political system was symbiotic; both the economy and the polity had been comprised of small units, and the expectation was that most of the coercive power to discipline the behavior of economic actors came from spontaneous and indeed invisible hands of other market actors; it was the quintessential self-regulating system guided by the invisible hand of market forces. In such a symbiotic situation, the human agency of judges and legislatures was involved in promoting development, as we saw in Chap. 7, but little public attention was needed to coordinate those efforts. Horwitz argues that common-law decisions based upon common sense interpretations of English traditions were adequate; the markets were so small that coordination could be intuitive.

However, as the 19th century progressed, this formerly successful model became increasingly inappropriate; the lower costs and unprecedented economic power of the new firms called the atomistic economic model and its supporting notions of self-regulating markets with a weak state, into question. With more and more calls for the promotion of economic development, as, for example, with roads, canals, or railroads, questions arose regarding an entrepreneurial role for a political authority. Should a political decision-maker govern the process and, if so, should it be federal, state, or local? And who should make these decisions, using what rationale? The existing rationale was an economic theory of laissez-faire, designed to explain and regulate the world of atomistic competition, still by far the dominant fraction of economic activity in terms of output and employment. But this rationale would make less and less sense in the context of the rapidly growing and ever more powerful monopolistic segment of the dual economy.

By the 1850s, some of the new firms, such as railroads, coal mines, and steamships, utterly dwarfed the atomistic units of the traditional production system, and by the 1880s, the new giants could easily acquire or absorb dozens or even hundreds of such atomistic units, while driving large numbers of the remainder out of business because they were too small to achieve the necessary economies of scale. Such dramatic change led to several questions of governance: Should these processes of economic concentration be encouraged by a state government in order to speed its development relative to a neighboring state? Or should concentration be limited or perhaps even retarded in some way to mitigate undesirable accumulations of power? Should states be allowed to set such developmental policies in their own interests, even if their decisions impinged unfavorably on neighboring states or even the national economy? Should a new economic rationale, other than laissez-faire, be considered, and, if so, from what sources might it be derived? And regardless of the preferred answers to such questions, which agents should decide: the legislatures, the courts, or perhaps the large firms themselves?

In exploring these issues of power and accountability, this chapter follows the lead of Yale sociologist Charles Perrow in his book *Organizing America: Wealth, Power, and the Origins of Corporate Capitalism*.[3] Perrow identifies the decisions of human agents in legislatures and courts as supplementary to the broad natural forces of economic development and as enabling, though not ensuring, regulation of these same economic actors. In addition, this chapter draws upon the work of legal scholar Morton Horwitz, who, in his two volume legal history *The Transformation of American Law: 1790–1860* and *1870–1930*, points first to the pervasive use of the law during the 19th century to promote business interests, often at the expense of consumers and labor, and second, to the later efforts of some of these same agents to regulate the powers of the firms.[4]

As articulated in this chapter, the story of early US capitalist governance is one of a nearly 300-year commitment to a laissez-faire model of economic development. It is a story that begins and ends with the decisions of political, legal, and economic actors promoting this model, thus disputing the assumption that actions were largely shaped if not quite controlled by "natural" market forces. In telling this story, the chapter focuses on the transformation of the US business enterprises from an atomistic scale to one that would later be called oligopolistic; it does so by laying out the characteristics of this transformation and then searching for its root causes by asking two sets of questions. First, how was US capitalism transformed to permit a huge increase in the concentration of economic power in the hands of an economic oligarchy with consequent economic, social, and political inequalities

[3]Charles Perrow, *Organizing America: Wealth, Power, and the Origins of Corporate Capitalism* (Princeton: Princeton University Press, 2002).

[4]Horwitz, *The Transformation of American Law, 1780–1860*; Morton J. Horwitz, *The Transformation of American Law, 1870–1960* (New York: Oxford University Press, 1992).

by the end of the 19th century such that this oligarchy, in fact, threatened to subvert US democracy, and to what extent was the transformation facilitated by human agency in legislatures and courts, as contrasted with the natural forces of the growing national market, and the Industrial Revolution? And second, how adequately was the economic oligarchy held accountable through a combination of competition and regulation to the United States' young democracy, and why? Simply put, these two questions look at how American capitalism changed in terms of empowering firms on the one hand and regulating them on the other; empowerment of private firms was deemed necessary to develop the new technologies and markets while increased regulatory powers were called for to hold those same firms accountable to society for the powers that they were permitted to develop.

Outline of the Chapter

This chapter begins by reviewing the unique circumstances of the United States as it entered the 19th century. After highlighting the factors initially contributing to the United States' early success, socially, politically, and economically, the chapter then turns to the key characteristics of its transformation into an established economic power at the end of the 19th century. In reviewing the changes during the 19th century, it focuses on the transformation of US capitalism in terms of the powers and the accountability of private firms. Specifically, it notes how the changes that took place in the scale and scope of some of the leading firms were not matched by corresponding changes in the regulatory powers of the state, such that the state could not hold these far more powerful firms accountable to the expectations of US society, as reflected by legislative as well as regulatory decisions. This discussion thus helps explain the large increases in economic inequality that were brought on by the 19th-century transformation of US capitalism, and thereby sets the context for the two investigative questions of the chapter.

Next, the chapter turns to the first line of inquiry, asking: were these relatively unregulated increases in corporate power more or less inevitable consequences of industrialization per se? Or, rather, were they a reflection of the competition for power among the leading actors, economic, political, and legal (especially judicial)? This discussion leads directly to the second question, which seeks to identify the rise in US economic inequalities and related oligarchic behavior within the new institutions of capitalism. How and why would a robust new democracy allow the growth of such a powerful oligarchy? Was this a political failure to maintain the accountability of these new actors to society?

Finally, this chapter aims to position the reader at an improved vantage point, from which to judge the post-1980 transformation in US capitalism described in the following chapter, when inequalities in income, wealth, and power again increased dramatically. The three chapters on the case of the United States—Chaps. 7, 13, and 14—explore quite different sets of power relationships between the nation's public and private sectors: Chapter 7 focuses on 200 years of symbiosis, wherein both public and private sectors were weak, roughly balanced, and adequately disciplined though markets; this chapter examines a period of dramatic ascendancy by the private sector as the United States became a business-oriented and even business-dominated oligarchy from 1830 until circa 1937; and Chap. 14 examines a second period of rising business dominance after 1980, which occurred, paradoxically, at the time when the US government was the most powerful in the world.

Pre-1830: Sowing the Seeds of Economic Growth and Rising Inequality

During its first two centuries the United States emerged as a nation from a specific set of unique geographical, technological, and historical circumstances. First, the American colonies inherited several remarkable geographical endowments, including a vast amount of very lightly populated, rain-fed land, an expansive network of rivers and minor waterways, and exceptional natural resources. Such a combination favored certain developments: an initially atomistic society of spread-out people and markets, an infrastructure combining road with canal transportation, and, north of the Chesapeake, a relatively egalitarian society absent the slavery of contemporary Latin American colonies and the US South.

Second, several industrial technologies emerged during the early 19th century that, in turn, impacted this setting, notably steamships, the telegraph, and the railroads. Such technologies spread rapidly; between 1815 and 1817, for example, the number of steamboats on the western rivers grew from 14 to 69.[5] Even though steam power was not rapidly adopted on canal boats, canal and turnpike transportation still sped up travel significantly and investment in them grew from barely $1 million in 1820 to $7.5 million in 1830.[6] A network of railways took hold of the nation starting in the 1840s.[7] Together, these technologies advanced communication and transportation systems that would, in turn, draw together the atomistic society of early America into a more integrated set of markets and a more unified, national society. For instance, the travel time from New York to Chicago dropped from 6 weeks in 1800 to 3 weeks in 1830 to 1 day in 1857.[8]

Third, the British colonists who established the new nation brought with them the memories of political and economic abuses by their monarchs, as well as more recent experiences of colonial self-rule, both based upon relations with its parent country, i.e., Britain. As Perrow notes, such a history was formative for the early United States: "American colonists feared the concentration of both wealth and power; they had seen it in England and Europe, and wanted to avoid it in America."[9]

[5]Chandler, *The Visible Hand*, 33–34.

[6]US Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970, Biencentennial Edition, Part II* (Washington, DC: U.S. Bureau of the Census, 1975), 766.

[7]Chandler, *The Visible Hand*, 82.

[8]Ibid., 84.

[9]Perrow, *Organizing America*, 33.

Political leaders and the public in general operated under this aversion to central power and thus entrusted the governance of the newly settled continent to a weak state in combination with increasingly powerful firms.

Arguably, just as formative as these pre-1830 American circumstances were the actions and decisions of political and legal leaders in response to them. Jefferson's leadership in drafting the Northwest Ordinance circa 1785–1787 helped define a unique set of property rights for the nation. In an effort to encourage settlement of the land, the Northwest Ordinance offered incentives built around the idea of a wide distribution of property: absolute rights for the property owner, including ownership of the sub-surface mineral rights, and local (not central) taxation of the property after the initial sale. Jefferson sought to empower individuals and local communities while limiting the power of the federal government.

Leaders of both the legal and political worlds responded to emerging industrial technologies in their decisions dealing with industrial actors. As noted by Horwitz, beginning in the early 19th century, the courts generally favored the development and application of new technologies, ruling in favor of entrepreneurs and developers. After the American Revolution, judges departed from the 18th-century notion[10] that the legislature alone could direct and defend changes to social and economic institutions;[11] instead, they operated under the premise that the judiciary was empowered to "mold legal doctrine according to broad conceptions of public policy . . . judges began to conceive of themselves as legislators."[12] The public policy on which most judges focused was the economic growth of the emerging nation. Horwitz notes the "forging of an alliance between legal and commercial interests" between 1790 and 1820,[13] such that the judiciary's efforts to encourage growth rivaled those of the legislature. Or, in his words, "every bit as significant as overt forms of direct legislative financial encouragement of enterprise were the enormous, but hidden, legal subsidies and resulting redistributions of wealth brought about through changes in common law doctrines."[14]

The building of new mills, dams, and canals provided many instances for such "hidden, but legal subsidies" early on. In 1795, Massachusetts state legislators lowered the penalties mill owners had to pay for damage to their neighbors' property in the event of flooding, according to the Massachusetts Mill Dam Act. Similar court rulings and legislation would follow throughout the 19th century with respect to the development of the nation's new canal and railroad systems. For instance, in the 1805 case *Palmer v. Mulligan* from the highest state court in New York, the presiding justices allowed a riparian mill owner to obstruct the flow of water in his community in order to run his mill.

[10] Horwitz, *The Transformation of American Law, 1780–1860*, 1.

[11] Ibid., 2.

[12] Ibid., 22–23.

[13] Ibid., 140.

[14] Ibid., 100.

Third, and perhaps most evidently, leaders both political and legal acted in response to the American colonists' fear of centralized power. This was most apparent in the Framers' division of governmental powers between the three branches (executive, legislative, and judicial) and the two primary levels of government (federal and state) in the Constitution, as ratified in 1788. Not long after, in 1817, James Madison, as President, vetoed the Bonus Bill, a bill that would have allowed federal financing of public projects via a permanent fund paid for by dividends earned from stock in the Second National Bank. Madison's veto stalled several projects supported by the states, such as the construction of the Erie Canal in New York; states would subsequently initiate their own local funding of such projects. Madison's defense of his decision explicitly manifests his fear of centralized power: he argued that "such a power [to finance public projects] is not expressly given by the Constitution" and that "the permanent success of the Constitution depends on a definite partition of powers between the General and the State Governments."[15] Echoing Madison's concern, legal writers and judges at the time (and throughout the 19th century) similarly resisted interventions by the federal government within the national economy. However, as Horwitz explains, judicial opposition to such exercises of federal power most directly resulted from judges' adherence to the doctrines of what he termed Classical Legal Thought, a laissez-faire ideology that sought to separate the law—including the federal agencies creating and enforcing it—from political, social, and economic concerns.[16]

As a result of these decisions to limit federal power, specifically in the realm of financing economic development, political leaders at the state level then stepped up. For example, state governments took control of the business of chartering new organizations, making their own decisions to regulate the process by requiring "public purposes and public review" or, later, to adapt it to their economic and private interests by issuing limited liability charters as early as 1811.[17] Leaders in the realm of law also appeared influenced by America's aversion to great government power, as demonstrated by the decision of the Supreme Court in *Dartmouth v. Woodward*. According to Chief Justice John Marshall's majority opinion, a corporation has "individuality" and "is no more a state instrument, than a natural person exercising the same powers would be."[18] In other words, "corporations, like people, could have private rights" and consequently, corporations such as Dartmouth should, like people, be kept free from political interventions and government control, even at the state level.[19]

[15]Lance Banning, *Liberty and Order: The First American Party Struggle* (Indianapolis, IN: Liberty Fund, 2004).

[16]Horwitz, *The Transformation of American Law, 1870–1960*, 10.

[17]Perrow, *Organizing America*, 33.

[18]Chief Justice Marshall, quoted in *Dartmouth College vs. Woodward*. 17 US (4 Wheat.) 518 (1819).

[19]Perrow, *Organizing America*, 41.

Two major themes stand out from these activities: the establishment of a weak state, especially at the federal level, and the prioritization of private economic interests over the public interest. Both themes are emphasized by Perrow, though he does not group them by specific cases in the way I do here.[20] First, the federal government of the nascent United States was granted limited powers upon its inception which were not only upheld in their narrow scope but were further limited well into the 19th century. Such a strict circumscription of powers is evident in the aforementioned divided powers in the US Constitution, President Madison's veto of federal involvement in public works, and the very limited size of the federal bureaucracy relative to the size of the country or its population, as noted so astutely by de Tocqueville. Second, private economic actors were granted more and more power to pursue their interests within the developing nation, including the power to develop the foremost public good of the time—the railroad—a public good that would by contrast be developed by the state in many other industrial societies of the time.

Essentially, the pre-1830 cases and the two main themes arising from them illustrate how the early United States became increasingly directed by private economic interests largely unaccountable to any public regulatory authority, state or federal. The seeds of inequality were sown, creating opportunities for the exercise of economic power which would in time increase to such a degree that it would be able to transform the relatively egalitarian society of the Founders toward an oligarchy. Was this trend toward increasing inequality inevitable, or desirable?

1830–1850: From Egalitarian Beginnings to Inegalitarian Inclinations

Between 1830 and 1850, the relatively egalitarian society of early America began to move toward a less equal distribution of wealth and power. Industrial technologies emerged, reshaping the common modes of transportation throughout the country while tilting power toward those financing and administering them. By granting private entrepreneurs the right to build the critical component of the nation's new infrastructure, the federal government lost the primary agency by which it could have taken a controlling role in the economy, thus tilting power toward state, local, and private economic actors. And to borrow a phrase from Joel Seligman, a leading expert on corporate law, state governments "raced to the bottom" to attract new firms to their states, effectively tilting power toward those owning and investing in firms.[21]

[20] Ibid., 217–219.

[21] Joel Seligman, *The Transformation of Wall Street* (Boston: Houghton Mifflin, 1982), 42, as quoted in Mark L. Roe, "Delaware's Competition," *Harvard Law Review* 117, no. 2 (December 2003): 602.

Egalitarian Beginnings

In 1830, the United States was still a primarily rural, sparsely populated country. Firms were typically owner-operated, often with a staff of only one or two. Like Adam Smith's notional pin factory, they used little or no power-driven machinery. Into the 1840s, the American North was close to an atomistic capitalist society, with small farms, small firms, mostly small markets, and small government. While plantations could be a source of private wealth and power in the south, there were almost no large centers of private power in the North. Competition operated as classical economics predicted; in Chandler's words: "Investment decisions for future output, as well as those for current production, were made by many hundreds of small producers in response to market signals, in much the way Adam Smith described."[22] Unless sited on a waterway, the trading radius for most goods was likely less than 20 miles, governed by the daily limits of a horse- or ox-drawn vehicle.

Local governments played the primary role in mobilization and disbursement of public funds. Local and municipal government collected 57.1% of total tax revenue, with states collecting 17.4% and the federal government 25.5% of the total,[23] a pattern that held until 1930 except during periods of war. Americans' experience with their democracy was overwhelmingly local; political power was as decentralized as economic power.

Thus, the political and economic systems of the postcolonial United States each comprised small operating units almost totally lacking hierarchical structure. Widespread property ownership buttressed early visions of American egalitarianism. Indeed, democracy itself was responsibly lodged with property owners, who had a literal stake in the country. This democratic tradition, while not exclusively rural, was "formed on the farm and in small villages."[24] The "democratic momentum" that swept the country in the wake of the American Revolution considerably expanded one essential signifier of democracy, the right to vote. With the installation of universal white male suffrage (except for South Carolina) by the election of 1828—coupled with the extension of the franchise to black men in a few New England states—"the political system of [the North and West] and its social base can be characterized as an agrarian democracy."[25] With the loosening of property requirements, enfranchisement was increasingly premised on the assumption of an enduringly egalitarian population.[26]

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[22] Chandler, *The Visible Hand*, 62.

[23] Sokoloff and Zolt, *Taxation and Inequality*, 35, Table 4.

[24] Hofstadter, *The Age of Reform*, 7.

[25] Dietrich Rueschemeyer, Evelyne Huber Stephens, and John T. Stephens, *Capitalist Development and Democracy* (Chicago: University of Chicago Press, 1992), 125.

[26] Alexander Keyssar, *Right to Vote: The Contested History of Democracy in America* (New York: Basic Books, 2000), 45.

Technological Breakthroughs

From the 1830s, the application of water and steam power to the production and distribution of goods began to propel a transformation of US capitalism. Before 1840, the United States was powered by "humans, animals, wind, and water,"[27] with "the traditional form of enterprise" securely in place.[28] According to one calculation, "by land, in 1815, it cost an estimated 30 cents to carry one ton of goods a distance of one mile. By boat upstream, the cost fell to 6 cents; by raft downstream to 1.3 cents; by ocean to less than one cent."[29] Upstream travel by haulage was prohibitively expensive, however: up to $100 per ton.[30] As a result, while 1,800 flatboats are recorded as arriving in New Orleans in 1807 from as far north as Pittsburgh, "only a hundred boats departed upstream."[31]

At the leading edge of the Industrial Revolution was the water-driven textile mill, which harnessed flowing water to drive machinery that relocated spinning and weaving from private homes to factories. By controlling production and distribution of the resulting output, private mill owners gained access to unprecedented wealth and the resources that wealth brought, thereby laying the basis of a new dilemma: the application of power accelerated economic growth, promoting prosperity, opportunity, and choice, but the effective use of this power, through managerial control of machines and people in factories and on railroads, vested a select few with enormous power to influence the lives of others. The tension of this dilemma would only intensify as new technologies emerged, particularly with respect to sources of industrial power

In 1850, animal power still accounted for more of the "horsepower" used in the United States than steam engines and water power combined. Steam power surpassed wind and water power by 1849, however, and it surpassed all other forms combined by 1889 (see Table 13.1).

Beginning in the 1830s, the adoption of the steam engine and the telegraph brought change on a large scale. The steam engine allowed ships to sail on their own power up river as well as down, enhancing commerce on the Mississippi and Ohio Rivers, as well as inland lakes. But steam power had even greater impact when set to work on steel rails, hauling freight and passengers at previously unknown speeds.

According to Alfred Chandler, the railroad and the telegraph were "the first modern business enterprises to appear in the United States."[32] They were integral to the

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[27] Chandler, *The Visible Hand*, 50.

[28] Ibid., 62.

[29] Atack and Passell, *A New Economic View of American History*, 147, quoted in Jack Beatty, *Age of Betrayal: The Triumph of Money in America, 1865–1900* (New York: Alfred A. Knopf, 2007), 9.

[30] Atack and Passell, *A New Economic View of American History*, 156.

[31] George Rogers Taylor, *The Transportation Revolution, 1815–1860* (New York: Rinehart, 1960), 5, quoted in Beatty, *Age of Betrayal*, 9.

[32] Chandler, *The Visible Hand*, 70.

Table 13.1 Horsepower of prime movers in the United States, 1849–1923

	Horsepower (thousands)					
Year	Steam engines and turbines	Internal combustion engines	Waterwheels	Windmills	Work animals	Total
1849	1,228	–	662	429	7,747	10,066
1859	3,263	–	930	639	10,961	15,793
1869	6,215	–	1,205	452	11,275	19,147
1879	11,636		1,353	507	15,324	28,820
1889	24,281	17	1,522	566	21,311	47,697
1899	38,445	924	1,860	658	22,274	64,161
1909	77,055	5,712	4,022	822	25,262	112,873
1919	116,380	27,563	7,650	836	24,221	176,650
1923	125,773	72,792	9,598	851	21,500	230,514

Note: Figures exclude pleasure automobiles.
Source: Carroll D. Daugherty, *The Development of Horse-Power Equipment in the United States*, U.S. Geological Survey Water Supply Paper 579 (Philadelphia, 1927), 48, Table 4, quoted in Louis C. Hunter and Lynwood Bryant, *A History of Industrial Power in the United States, 1780–1930*, Volume III: The Transmission of Power (Cambridge: MIT Press, 1991), 108, Table 7

development of the much larger markets that would, in turn, induce the creation of much larger firms in industries that could take advantage of "the fast, regular, dependable transportation and communication so essential to high-volume production and distribution—the hallmark of large modern manufacturing or marketing enterprises."[33] Railroads provided a fast, regularly scheduled, reliable, and efficient conduit between the small, far-flung centers of American business.[34]

The atomistic society of the United States was gradually knit together into a more integrated entity during this time; people, goods, and markets were connected in a common as never before. And as a result, those doing the connecting—the managers and financiers of the new infrastructure—were concentrating power as never before. Additionally, railroads were a classic case of increasing economies to scale and scope. Larger firms could capture those economies through internalizing them, for instance, by completing a railroad from one destination to another. Perrow explains that "monopoly was built into the *technology* ... free markets would not work here. Whoever owned the railway, whether private or public, would have to control it completely."[35] He argues that the new transportation technology required unprecedented amounts of funding and coordination, so those who could supply them were bound to accrue unprecedented amounts of power. Given America's

[33] Ibid., 79.
[34] Ibid., 49.
[35] Perrow, *Organizing America*, 98.

general aversion to great government power at the federal level, the states and eventually private individuals would take on this "monopolistic" role and the power that came along with it.[36]

Institutional Innovations: The Rise of Corporate Law and the Modern Business Enterprise

Both technological and institutional changes contributed to increases in American productivity, but also to the concentration of wealth, and the tilting of power into the hands of a small number of individuals. The institutional changes included: the granting of state charters to firms undertaking complex infrastructure projects; the rise of the general purpose corporation with its grant of limited liability for shareholders and its institutionalization of the right of firms to take in and lock up capital indefinitely; and, not least, the emergence of the modern business enterprise itself.

Early corporations were granted special charters that restricted their ventures to very limited purposes, such as building and operating bridges, roads, or colleges. Often they were granted only for a specified period of time.[37] Starting in 1811 the state of New York began to loosen these restrictions, an early manifestation of the movement from the Grant Theory to the Free Contract Theory of corporations, noted above. To avoid risking a loss of income from incorporating companies as well as to satisfy a "desire for business expansion" that, in his dissenting opinion in *Ligget v. Lee*, Justice Louis Brandeis retrospectively noted "created an irresistible demand for more charters,"[38] other states opted to follow New York's lead. By 1850 special charters had almost wholly been replaced by general purpose charters, permitting private parties to easily establish a corporation with the powers to act as a legal person.[39] The Free Contract Theory of corporations had taken hold of both the judiciary and the state legislatures. Those who controlled these corporations could now mobilize and control the distribution of resources for whatever purposes they wished, subject to the general laws of the state and nation. Since charters typically did not impose any requirements on corporate decision-making processes, principles, or purposes, they tended to permit the concentration of much of the wealth they generated in the hands of the small coterie of self-selected persons that governed them.

State governments used charters to promote the development of key economic infrastructure and public goods including canals and banks. In this they often competed with the other states to attract economic activity. Justice Brandeis noted how general charters were soon linked to the self-interest of the states, a practice that

[36] Ibid., 102–103.

[37] Harry C. Henn and John R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3d ed. (St. Paul, MN: West Publishing Co., 1983), 25.

[38] Justice Louis Brandeis, quoted in *Ligget vs. Lee* 288 U.S. 517 (1933).

[39] Perrow, *Organizing America*, 36–37.

has continued ever since: "Whether the corporate privilege shall be granted or withheld is always a matter of state policy. If granted, the privilege is conferred in order to achieve an end which the state deems desirable."[40] As noted earlier in the chapter, both the Free Contract Theory of corporations and state competition for the revenue of incorporating firms played a role in permitting the creation of the limited liability corporation.[41] The corporation was no longer seen as an artificial entity but as the aggregate of its shareholders, but unlike a partnership each shareholder could only be held liable for his own investment in the corporation. Specifically, this corporate model limited investor losses in the event of corporate bankruptcy to their invested capital, in effect granting them unlimited upside reward for limited downside risk and creating an important incentive for investment in a new nation as yet limited by small markets, high transportation costs, and little investment capital.

In addition to this right of limited liability, the corporation was also granted the right to "lock-in" capital, i.e., raise funds directly from investors without the obligation of returning them on demand. This right arguably contributed even more to the power of private firms that the more noted right of limited liability, as argued by Margaret Blair, a professor of law at Vanderbilt. Blair writes:

> Perhaps as important as protecting the assets of the enterprise from the participants' *creditors* [i.e., limited liability], however, was the role that incorporation played in establishing a pool of assets that was not subject to being liquidated or dissolved by *any* of the individual participants who might want to recover their investment. . . . Such a protected pool of assets could therefore be committed more credibly to the enterprise for a substantial amount of time. Investors in corporate shares could subscribe in small units, but once the funds paid to purchase those shares had been committed, limits were imposed—sometimes severe ones—on the ability of investors to withdraw funds from the business.[42,43]

According to Blair, the right to lock-in capital existed, in various forms, from the advent of corporate charters in the United States, i.e., as early as the late 18th to early 19th centuries: "Once committed, the capital paid into a corporation by its initial investors could be very difficult to recover. Early charters and statutes typically specified that shareholders, or 'members' as they were likely to be called, could not withdraw their capital unless the enterprise was formally dissolved."[44] Over the course of the 19th century, together with entity status and the right of limited liability, the right to lock-in capital transformed and empowered the US corporation, making ". . . it possible to build lasting institutions. Investments could be made in long-lived and specialized assets, in information and control systems, in specialized knowledge and routines, and in reputation and relationships, all of which could be sustained even as individual participants in the enterprise came and went."[45] Thus

[40] Brandeis, in *Ligget vs. Lee* 288 U.S. 517 (1933).

[41] Perrow, *Organizing America*, 208.

[42] Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century," 125. Italics original.

[43] Ibid., 392. Italics original.

[44] Ibid., 430.

[45] Ibid., 454.

was the incredible power of corporate law—via the Entity Theory, limited liability, and locking in capital—in shaping the model of US capitalism throughout the 19th century toward a laissez-faire model in which the private firm prevailed in terms of both economic and legal power.

Perhaps the most important institutional innovation of all, in addition to corporate law, was the emergence of the modern business enterprise. Thanks to its hierarchical organization, whereby a new class of professional managers oversaw operations, it was able to overcome the critical coordination problems posed by the very scale, complexity, and speed of the internal operations that were required to take full advantage of the new technologies.

Basic markets prior to the modern business enterprise worked according to economic theory for trading relationships among activities that could be autonomous from one another. Thus, the firms that emerged early on were too small to coordinate productive processes for the transformation of resources from one form into another, such as from iron and coal into steel. This was particularly the case when speed or a continuous flow of work in process dictated that these activities—such as the transformation of molten iron into steel, or molten steel into rails and tubes, or scheduling locomotives and tracks in order to move freight and passengers at optimal speeds to varying destinations along a single set of rails—be integrated and closely supervised. Essential to the internal workings of the early forms of the modern enterprise, therefore, was the task of learning how to coordinate operations that had to be tightly integrated in order to run safely and effectively.

Textile mills were one of the earliest examples. Chandler notes that though they faced fewer coordinating needs than railroads, "the textile mills were, nevertheless, pioneers in the technology of modern production. They did internalize and integrate all or nearly all of the processes of production involved in making a product within a single mill."[46] This internal synchronization of business operations was overseen by an early form of the managerial hierarchy of modern business; workers were now empowered to perform their individual tasks on a carefully integrated set of activities, often using a central source of power within one location under the direction of one manager or set of managers. In other words, water-driven and then steam-driven textile mills could greatly accelerate the speed of production of thread and cloth if the application of power came from a central source rather than from the dispersed and individually much more limited power of human spinners and weavers. The transmission of water or steam power from its source—whether a dam or a steam engine—to the various workplaces was more efficient if concentrated in a single factory than if spread through the homes in various villages, as it had been in traditional putting-out systems. This new use of a single power source implied the reliance on some sort of managerial hierarchy to coordinate effective operations. While the output was still sold in markets, several intermediate steps that local, spread-out markets had independently coordinated in the past were now integrated within a single firm and placed under centralized control.

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[46] Chandler, *The Visible Hand*, 72.

In this way, integration of activities was the fundamental rationale for firms, while disconnected transactions were the rationale for markets. The development of power machinery demanded scale to achieve technical potential, throughput to achieve economic efficiency, and the coordination of numerous and varied functions, from production to sales, to achieve both scale and steady throughput. In this process the visible hand of a manager would replace the invisible hand of the pricing mechanism.[47] Textile mills were early innovators in the development of the firm with its centralized management; the railroads would soon follow in the 1850s and 1860s with further advances to the managerial hierarchy of the modern business enterprise.[48]

The Second National Bank: A Missed Organizational Vehicle for a Different America

The very idea of a national bank, let alone the actual institution, was a controversial idea in the early days of the republic. Conflict over the Second Bank of the United States (1816–1836) between President Jackson and the Bank's supporters highlights the persistent postcolonial American fear of centralized federal authority, a fear that effectively constrained the expansion of credit-based economic development and removed the federal government from a direct role in shaping the economic landscape until well into the 20th century.

The First Bank of the United States lost its official charter in 1811 when President Madison allowed its official powers to expire largely on constitutional grounds—it represented an unwarranted extension of Federal power. However, when a shortage of funds and of means of payment caused a near disaster in the War of 1812, and led President Monroe to post personal guarantees in order to transfer funds so that Andrew Jackson could mobilize an army to protect New Orleans, even some of the leading strict constructionists favored re-chartering. As a result, the Second Bank was chartered in 1816, with a 20-year mandate like its predecessor, with a capital base of $35 million which, given the growth of the country, was roughly comparable in size relative to its predecessor.[49] However, it was by far the largest US bank. In addition to taking deposits from and making payments for the federal government

[47] Ibid., 12.

[48] Perrow, *Organizing America*, 81–83; Drawing upon the work of Philip Scranton, Perrow notes that the textile industry did not inevitably lead to the managerial capitalism developed and practiced by the railroad industry. Philadelphia textile firms relied upon a system of "small, networked firms" and "flexible production" that arguably achieved just as efficient results as the system of "large, centralized, bureaucratic, mass-production and mass-distribution firm" upon which the railroad industry relied (95). The Philadelphia system was thus a viable alternative to the corporate industrial model up until the 1880s, at which time the latter was taken to be the norm, a natural system evolved from US capitalism.

[49] Edwin J. Perkins, "Lost Opportunities for Compromise in the Bank War: A Reassessment of Jackson's Veto Message," *The Business History Review* 61, no. 4 (Winter 1987): 544–545.

it was allowed to make commercial loans, and to operate on a national and international scale to provide local services and to finance trade. It soon maintained an administrative network of dozens of branches throughout the country.[50] With its powers to make commercial loans and to operate what amounted to a nationwide network of branches that made payments on behalf of the Federal government, it is arguable that it had even more power than a contemporary central bank, especially if it were to choose to make loans to important politicians or their friends.

Later historians[51] concur that the Bank proved beneficial to the economy in its promotion and regulation of a stable, uniform currency and its facilitation of business development. In its day, however, the Bank was a locus of controversy. As the exclusive holder of a national charter, it was far larger than any of the state-chartered banks, its notes were legal tender, and it had the informal power to buy up the notes of smaller banks and present them for redemption, thus forcing these banks to maintain a special reserve on paper currency. The Bank thus maintained an informal capacity to limit the growth of bank notes, or what we would now call the money supply.

There were two key issues in the controversy: one was the extraordinary power of the Bank and the other was its lack of accountability to any political authority. The Bank was empowered to act as an agent of the Federal government by holding deposits for the government and making payments for it, creating loans that served as legal tender, and buying up loans that would limit the money supply. However, the Bank operated as a public–private hybrid: while chartered by the federal government and obligated to take on federal debt, it drew most of its revenues from the private sector, from interest on commercial loans. In this latter capacity, it competed with state-chartered banks, but unlike them the Second Bank was exempt from state and local taxes on property and capital.[52] With branches in major cities, tax-exempt status, the right to grant or withhold loans from individuals, and the right to hold notes from smaller banks or to call them for redemption at its own choice, the Bank's "very existence [was] a major political issue."[53] It had the power to cripple or wipe out a local bank if it chose to.

The crux of the power issue ultimately focused on the governance structure for the Bank. Since 20% of its capital had been provided by government, and its board represented its shareholders, the Bank was, in fact, under private control, especially once Nicholas Biddle, a prominent financier, became its chairman. With this governance structure and a strong and able chairman it was not accountable to the government. Thus the Bank had vast power with little accountability.

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[50] Chandler, *The Visible Hand*, 30.

[51] One possible source is B. H. Beckhart, "Outline of Banking History from the First Bank of the United States Through the Panic of 1907," *Annals of the American Academy of Political and Social Science*, Vol. 99, The Federal Reserve System—Its Purpose and Work (January 1922): 1–16.

[52] Perkins, *Organizing America*, 532.

[53] Chandler, *The Visible Hand*, 31.

When Andrew Jackson successfully ran for President in 1828, it was as an opponent of re-chartering the Bank. Aware of this, and facing the expiration of the existing charter in 1836, the chairman and supporters of the Bank sought re-chartering from Congress in 1832 in an attempt to leverage the political pressure of an election year to thwart President Jackson's known opposition to the Bank.[54] Jackson took the timing of this re-chartering initiative as a direct challenge to his political power as well as to his ideas about the powers and accountability of the Bank. Consequently, a dispute that might have been settled by a compromise, with some restriction of the powers of the Bank and/or increased accountability to the Federal government, instead escalated into what became known as the "Bank War" which lasted for 8 years.[55] Jackson not only vetoed re-chartering the Bank, but he also unilaterally withdrew its government deposits, terminated the Bank's role in collection of taxes and payment of government expenses (for example, to veterans), and terminated the role of the Bank's notes as legal tender for all debts. Simply put, Jackson disempowered the premier agent of national economic power at the time.

Jackson's decision to destroy rather than reform the Bank would have long-lasting effects. The United States was left without a central bank for almost 80 years. During this time the US banking system had no lender of last resort and the federal government had no institution capable either of exerting a significant influence on money supply or on major investments, a power which might have allowed it to influence who funded the railroads and where they were built. Merchant bankers and state-incorporated banks partially filled these gaps, financing trade and providing local services, with only erratic government supervision.[56] Overall, during these 80 years or so, the economy had far less access to credit than it might have had and was thus much more vulnerable to recessions than it might have been, were it still overseen by a central bank. Specifically, the US railroads laid far more track than was needed, many of the railroads went bankrupt, and the US economy experienced prolonged downturns in the 1840s and 1870s, and an acute crisis in 1907.

Why would American leaders wait almost 80 years, for the financial crisis of 1907, before chartering another central bank? The first and most obvious reason was because of the extreme political polarization and animosity that had been generated by the Bank War. A second reason lay in the widespread fear of central power that it represented. From this latter perspective, the Bank posed a threat of systemic corruption, or in the words of economist John Joseph Wallis, the manipulation of the economy for political ends. Wallis notes that in "the late eighteenth and early 19th centuries Americans were fixated on systematic corruption as the nation's primary political problem."[57] In speaking out against the Bank, Jackson drew on his contemporaries' fear of such corruption, calling the Bank a government unto itself,

[54] Perkins, *Organizing America*, 533.

[55] Robert V. Remini, Andrew Jackson and the Bank War (New York: W.W. Norton & Company, 1967), 77 ff.

[56] Chandler, *The Visible Hand*, 31.

[57] John Joseph Wallis, "The Concept of Systematic Corruption in American History," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia

which sought to keep "political institutions, however well adjusted, from securing the freedom of the citizen, and in establishing the most odious and oppressive government under the forms of a free institution."[58] While perhaps an exaggeration, the solution arrived at in response—the elimination of corruption via complete elimination of the Bank—was hardly the only option available. For instance, the Bank could have been made accountable to the federal government through an act of Congress changing its charter to allow the president to appoint the Bank's board for fixed terms of office. In addition the Bank's powers might have been reduced. In any event it would only have exercised its powers under federal supervision; its authority and its accountability would therefore have been more properly balanced. However, Jackson did not propose such a scheme and Nicholas Biddle, head of the Bank, indicated an unwillingness to accept any reduction in the powers of the Bank.[59] Compromise might have been possible once the two protagonists had exited the scene, but still it took an extreme financial crisis 70 years later to actually revive the notion of a central bank.

With the demise of the Bank the nation lacked a strong federal economic agency and the states took a leadership role in the development of canals. Yet a recession in 1837 plus the advent of the railroads turned many of these canals into financial disasters and embarrassing bankruptcies, causing the notion of state-led industrial development to fall into disrepute.[60] This left the field of economic leadership open to the captains of American business, who would lobby state legislatures as well as Congress in their efforts to shape the structure of American markets and the deals done within them. It was as though the rulemaking role in an organized sport had been taken over by some of the largest players.

A Race to the Bottom by the States: Tilting Power Toward Private Actors

Given the limited capacities of the executive branch of the Federal government in the early 19th century, economic policy and regulation were managed locally. Those economic policies that were set federally emerged from the independent, and as noted above, commercially oriented, decisions of the judicial rather than legislative or executive branches. Moreover, when the Federal Government did act "federal policies were essentially distributive, that is, they concerned the allocation of resources that were at federal disposal: land grant programs, tariffs, shipping subsidies, various internal improvements ... [and] the judge-made private law

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Goldin, A National Bureau of Economic Research Conference Report (Chicago: University of Chicago Press, 2006), 25.

[58] Andrew Jackson, "Paper read to the Cabinet" from the Jackson Papers, L.C., as quoted in Wallis, "The Concept of Systematic Corruption in American History," 47.

[59] Remini, *Andrew Jackson and the Bank War*, 77ff.

[60] Perrow, *Organizing America*, 128.

of contracts and torts established a general national policy of dynamic capitalist expansion ... favored business risk-taking and consequently capitalist economic development."[61] By the mid-19th century, federal economic policies were rarely restrictive or regulatory in nature.

At the state level, where regulatory powers were in effect delegated, governments exemplified, in Wallis' words, "the paradox of corruption and the promotion of economic development."[62] In response to basic concerns over systematic corruption, state governments enacted constitutional provisions that limited their legislatures to passing general incorporation laws that assured free entry into corporate status for all comers, thus curtailing incentives to grant charters to a "favored few."[63] Wallis argues that the competitive markets installed by states in the 1830s and 1840s—offered as a solution to the political problem of rent-seeking political machinations—effectively curtailed systematic corruption by reducing payoff.[64] Corruption at the state level was therefore reduced, but at the price of conferring increased power to private parties. Yet the states retained their ability to enhance the powers of firms, most notably the power to take advantage of the "common," i.e., a lightly regulated continental economy. State governments unofficially competed to attract firms to incorporate within their states, and any firms so incorporated had access to the US market.

Starting around 1837, the Free Contract Theory replaced the Grant Theory of the firm, such that one state after another passed general incorporation laws permitting firms to incorporate without requiring any official public purpose or project. The same domino effect occurred with respect to limited liability; once one state offered such an incentive to incorporate within its bounds, other states followed suit. In both cases, whether or not objections were raised to the lack of accountability by firm owners and investors, states were forced to either "race to the bottom" offering flexible charters relatively free of state oversight or risk losing a steady source of income from incorporating firms.[65] And the courts, set on using the law to promote economic development, did not intervene as corporations became increasingly independent from state regulation. In fact, by 1850 or so, judges generally viewed corporations as separate from the states granting them their corporate privileges.[66] Moving away from what Horwitz calls the Grant Theory of corporations, or the notion that the privilege of incorporation was tied to the pursuit of some limited

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[61] Robert B. Horwitz, "Understanding Deregulation," *Theory and Society* 15, No. 1/2, Special Double Issue: Structures of Capital (January 1986), 141.

[62] Wallis, "The Concept of Systematic Corruption in American History," 49.

[63] Ibid., 50.

[64] Ibid., 50–51.

[65] This pattern arises again in the 1880s when New Jersey led states to permit holding companies, or corporations owning stock in other corporations. Mark L. Roe draws primarily upon this case when discussing the idea of income-seeking states "racing to the bottom" in Roe, "Delaware's Competition," 602.

[66] Horwitz, *The Transformation of American Law, 1870–1960*, 74.

purpose sanctioned by the state granting the privilege,[67] judges adopted the Free Contract Theory of corporations, or the notion that the privilege of incorporation was less a creation of the state than "a normal and regular mode of doing business."[68] Horwitz describes the transition well: "to the extent that the corporation is thought of as an artificial entity created by the state [i.e., the Grant Theory], we would expect courts strictly to construe powers granted in the corporate charter and to refuse effect to corporate activity regarded as beyond the powers conferred. At the opposite pole, to the extent that the corporation is regarded simply as a convenient device for conducting business activity, not as a privilege or concession derived from the state [i.e., the Free Contract Theory], we would expect the death of the ultra vires doctrine."[69] Thus, legal notions of corporate responsibility to a contract with the state government or the public interest became more and more obsolete. In this way, interstate competition and evolving legal doctrines created a context in which efforts to curb abuses by *public* actors ended up effectively opening opportunities for abuses by *private* actors, reducing their accountability to the interests of the state or the public.

One example of such a lack of accountability stands out in the relations between the corporations and their workers. As it became common for firms to incorporate and operate with few or no restrictions, they were rarely called upon to account for the safety of their employees; as long as they contributed to economic growth at a state or national level, the methods by which they did so were neither looked into nor questioned. Perrow illustrates this lack of accountability through one noteworthy case in 1841, in which workers tried to sue a railroad for neglecting employee safety in the workplace.[70] Ultimately, the court sided with the railroad company, declaring that once an individual signed a contract to work for the company, he assumed full responsibility for the risks he would be undertaking while engaging in his work. The balance of power thus tilted increasingly in favor of those private actors running and financing corporations, a trend that would expand throughout the 19th century.[71]

Alternatives to the US Experience: Tilting Power Toward the Federal Government and Away from Private Actors

The experiences of other countries between 1830 and 1850 suggest that alternatives existed. America could have followed the path of its European counterparts,

[67] Ibid., 72, 75.
[68] Ibid., 73.
[69] Ibid., 77.
[70] Perrow, *Organizing America*, 177; see also John Fabian Witt, "The Transformation of Work and the Law of Workplace Accidents, 1842–1910," *Yale Law Journal*, 107 (1997–1998), 1469, citing *Murray v. South Carolina R.R.*, 26 S.C.L. (1 McMul.) 385 (1841).
[71] Perrow, *Organizing America*, 226–227.

whose national governments successfully built and operated public transportation systems—their railroads in particular—during the 19th century. Sociologists Frank Dobbin and Timothy J. Dowd note that "France has capitalized vital industries since the time of Louis XIV; Germany has encouraged cartels since the late 19th century."[72] Perrow confirms this observation, explaining that in France the state completely oversaw the development of firms and railroads; all efforts were centralized and professionally managed through the state.[73] He also describes Britain's similar, though certainly not as strong, efforts to regulate private economic interests; during the mid-19th century, the British economy was characterized by "private capital, ownership, and management, [and] was coordinated by cartels and regulated by state agencies set up by parliament."[74] Even Prussia took a stronger state stance than the United States during this time; by 1850 Prussian railroads switched from private ownership to state control.[75] However, plausible this broad characterization might be, it seems too simple, at least in the French case, of which more below.

The distinct circumstances of other countries certainly played a role in determining the method by which they funded, built, and generally related to firms and their public projects. In hindsight, it seems that both Germany and France had state-specific reasons of national defense for wanting to develop and control their railroads, in addition to those of providing what was arguably the most important public good of the time—an improved transport system that was so superior as to speed up and shape development wherever it was built. Indeed, in France the latter set of reasons motivated a corps of public servants drawn from an elite engineering school to take the initiative to design and develop a sophisticated national transport system.[76] The situations of the European countries and the United States also differed due to their drastically different demographics. Specifically, the European state-run initiatives had less scope than their American counterparts because Europe's major cities already existed and the railroads simply connected them, though of course there were competing ways to accomplish this in many cases. France, for example, established its system under private leadership with government support, and even some British participation. However, parliament voted the funds for planning a national system in 1833, and its corps of engineers promptly set to work to design it. But the design standards of the engineers proved costly and the French government did not have the funds to finance the system by itself, so it grew in irregular ways with private sector providing much of the capital and likewise insisting on operating control, but in a system that minimized duplicative waste.[77]

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[72] Frank Dobbin and Timothy J. Dowd, "How Policy Shapes Competition: Early Railroad Foundings in Massachusetts," *Administrative Science Quarterly* 42, no. 3 (September 1997), 501.

[73] Perrow, *Organizing America*, 106.

[74] Ibid., 109.

[75] Ibid., 110.

[76] Arthur Dunham, "How the First French Railways Were Planned," *Journal of Economic History* 1, no. 1 (May 1941), 12–25.

[77] Ibid., 18ff.

In the United States, on the other hand, much of the country was still undeveloped in 1840; railroads would therefore not only connect but also influence the location as well as facilitate the development of the nation's cities.

In effect the United States was delegating great powers to shape the development of its territory to private firms guided by private profits. There were big profits to be made in US railroad development in the form of local government grants to attract construction to favor one region over another. Competing railroads, instead of trained public agents, made crucial developmental decisions for the various states and regions based on profit-driven incentives. The results included duplication of routes, corruption, and eventually a series of bankruptcies that engulfed half of the nation's railroad mileage at one point in the 1890s. Although European experience showed that alternatives abounded as America began to build its national economy and infrastructure, on the other hand state-specific contexts played a formative role in determining the routes ultimately chosen.

In contrast to the alternatives-conscious arguments of Dobbin, Dowd, and Perrow, historian Alfred Chandler insists upon the inevitability of the United States' privatized path to developing the transportation technology of the 19th century. According to Chandler, technological imperatives drove the move to privatization; large, private firms, in fact, arose for the first time in direct response to the complex concerns to which industrial technology gave rise.[78] These concerns included the speed, scope, and safety of the new transportation systems, especially the railroads. As Chandler explains: "Technology made possible fast, all-weather transportation; but safe, regular, reliable movement of goods and passengers, as well as the continuing maintenance and repair of locomotives, rolling stock, and track, roadbed, stations, roundhouses, and other equipment, required the creation of a sizable administrative organization ... the operational requirements of the railroads demanded the creation of the first administrative hierarchies in American business."[79] Chandler's logic suggests that no existing institution—such as the government, state, or federal—was capable of developing and controlling the rapidly advancing technology. For him, the tilt of power into the hands of private economic actors was more or less inevitable as modern systems of transport, namely, the railroads, emerged in the United States during the 1840s. This tilt would only become more extreme as railroad technology and the firms managing it took over and transformed the United States during the second half of the 19th century.

Concerns arising from coordinating the industrial technologies of the 19th century certainly had to be addressed; someone had to take charge. But was it, as Chandler claims, inevitable for private actors in the form of large professionally managed firms to be this someone? Or are Dobbin, Dowd, and Perrow more correct in claiming that the United States had alternatives in handling the complex concerns of transportation technology? Like its European counterparts, it could have pursued a more public, state-run strategy in developing its public goods by authorizing

[78] Chandler, *The Visible Hand*, 82, 8, 12.

[79] Ibid., 87.

a number of state-owned railroads with regional charters. Whichever entities took charge would gain power, both economic and political, as the new technology connected people, goods, and markets across the nation. America's egalitarian society tilted away from federal agencies toward growth-seeking states and profit-seeking private economic actors. The empowerment of private firms to develop and operate critical infrastructure would, in turn, lead toward increased inequalities in economic and political power as the United States headed into the second half of the 19th century.

1850–1880: Institutional Innovation to Institutional Infighting

Between 1850 and 1880, the inequalities toward which the United States had inclined during the first half of the century became increasingly institutionalized in the form of modern managerial capitalism. Hierarchical organizations arose within the major firms of the time, inducing the creation of a new class of career managers that would come to dominate business and politics alike. The railroad industry in particular paved the way for increasingly concentrated power as leading firms attempted to integrate vertically in order to control the functions that were crucial to their service delivery. At the same time, they expanded geographically in order to create by any means possible stable sources of revenue to offset high fixed costs and competition. These ever-larger firms, with their new organizational model, created excess capacity, which ill-prepared the industry to face the depression of the 1870s, with its rate wars, bankruptcies, illegal consolidations, and innumerable cases of corruption—economic, legal, and political.

The Railroad Industry: A Model of Managerial Capitalism

The second half of the 19th century witnessed even more dramatic institutional innovations than the first half and, as Chandler points out, the railroads were the leaders in creating managerial capitalism. The building of not only the railways themselves but also the businesses running them boomed between 1850 and 1890, at which point problems both internal and external increased the regulations placed upon them. Chandler sums up this next stage in the development of the modern business enterprise as follows: "The new sources of energy and new speed and regularity of transportation and communication caused entrepreneurs to integrate and subdivide their business activities and to hire salaried managers to monitor and coordinate the flow of goods through their enlarged enterprises. The almost simultaneous availability of an abundant new form of energy and revolutionary new means of transportation and communication led to the rise of modern business enterprise in American commerce and industry."[80] In other words, the coordination concerns

[80]Ibid., 77–78.

of the railroad industry in the mid-19th century were unprecedented, necessitating unique administrative responses that would have a formative role in the rise of the business model of modern managerial capitalism.

Railroads were a revolutionary new form of transportation, connecting supply with demand, increasing turnover and raising productivity for a wide array of economic actors. In addition, and unlike textile mills, by necessity they operated through systems that connected several spread-out locations.[81] As a result, railroads (as well as telegraphs, used for communication along the railroad lines) posed challenging organizational problems for their owners that never arose for those owning and managing textile mills or most other enterprises of the time.[82] They could not be run based on face-to-face communication; they needed formal structures of power and accountability. The railroads were also financed differently, which presented further administrative problems. As Chandler notes, "railroads required far larger amounts of capital to build than did canals."[83] To illustrate: between 1815 and 1860 a total of $188 million was invested in the construction of canals, while between only 1850–1860 almost $700 million was invested in the construction of railroads.[84] Granted, railroad building boomed during those 10 years; this boom alone, however, cannot explain the expenditure. High fixed costs were involved in laying and maintaining railroad track of any length, and any railroad line that stopped only partway to its destination was worth little or nothing. As an immediate solution to these costs, railroad firms built the least number of tracks possible on which to run their trains. Because of their capital intensity, the cheapest and fastest way to build a railroad from one location to another was to lay a single track. This created a new challenge that markets were ill-equipped to solve: coordinating the movement of trains running in opposite directions along a single track, where timing was of crucial importance and mistakes could be very costly.

The Western Railroad experienced such costs first-hand. The road was divided into three main divisions that were operated separately yet ran along the same, single track. On October 5, 1841, the dangers of such uncoordinated operations became apparent; two passenger trains collided head-on, killing two and injuring 17 others. To continue operations effectively and safely, the firm and others like it clearly had to change their internal organization. The tragedy of the Western Railroad was in this way instrumental to bringing about change within the industry, bringing "into being the first modern, carefully defined, internal organizational structure used by an American business enterprise."[85] Railroads clearly needed a trained and well-managed staff to build and operate specific administrative structures, to communicate and coordinate traffic along the rails, and to allow high volumes to pass. Safe and efficient railroad operation "called for unprecedented organizational

[81] Perrow, *Organizing America*, 160.

[82] Chandler, *The Visible Hand*, 79–80.

[83] Ibid., 90.

[84] Ibid.

[85] Ibid., 96–98.

efforts. . . . No other business enterprise . . . had ever required the coordination and control of so many different types of units carrying out so great a variety of tasks that demanded such close scheduling."[86]

Management procedures within the industry had to adapt continuously to handle each unique challenge as it arose. Such changes included maintaining precise schedules, keeping reliable records, clearly communicating responsibilities, and adopting a hierarchy of accountability. Chandler notes that, as with the incident of the Western Railroad, each new procedure was developed and incorporated according to the needs of the major firms of the time; firms then built upon procedures that were proven to work by other firms. "Benjamin Latrobe of the Baltimore & Ohio concentrated on the needs of financial accounting as well as operational precision. Daniel McCallum of the Erie articulated the principles of management for this new type of business enterprise; while J Edgar Thomson of the Pennsylvania worked out the line-and-staff concept as a means of integrating more effectively the functional activities of several regionally defined operating units."[87] Together, these leaders of the railroad industry gradually gave shape to the functionally integrated organizational structures comprising the modern business enterprise.

As the hierarchical business model of managerial capitalism emerged within the railroad industry, a new sort of agent emerged along with it: the career manager. Career managers were remarkable in that they worked for firms without actually having an ownership stake; such a dissociated role was hardly conceived of prior to the 1850s.[88] Unlike the previous class of owner-managers, these managers were often experts educated in the engineering and/or business fields. As Chandler remarks, "the careers of the salaried managers who directed these hierarchies became increasingly technical and professional."[89] As a result, the internal hierarchy of the railroads was no longer run by families or long-time owners but rather by businessmen solely focused on doing their jobs. These men would drive the development of the industry during the rest of the 19th century, gradually accumulating power within their respective firms as well as within the US economy in general.

The railroad industry soon called not only for improved communication, coordination, and leadership but also for greater capital mobilization beyond the grasp of small firms. Previous public transportation projects, such as canals, were mainly funded by state entities. In the first half of the 19th century, for example, about 73% of funding for canals came from state and local governments, primarily through the selling of bonds to investors domestically and abroad.[90] Railroads required even larger amounts of capital that, according to Chandler, could be raised only in large commercial centers such as New York City, where private investors—Americans

[86]Ibid., 94.
[87]Ibid., 99.
[88]Ibid., 95.
[89]Ibid., 8.
[90]Ibid., 90.

and Europeans—bought and traded stock in the railroads.[91] Chandler did not consider the European model of an entirely state-owned railroad to be an option. For him, private investment was central to the US railroad industry and by 1860, New York City's Wall Street "was undisputedly the nation's primary market for railroad securities."[92]

While the main operating and funding of railroads tended toward the private sector as the century progressed, public sources nevertheless continued to support their development; between 1850 and 1870, 129 million acres of federal land grants were awarded to the railroads, in addition to financial aid from federal, state, and local government.[93] However, Perrow notes that the financial crisis of the late 1830s forced several states to eventually abandon the railroad industry such that private investors became the dominant financial influence within it.[94] (Here we see an instance where a successful federal economic agency, such as a legitimate if less powerful Second Bank of the United States, could have played a coordinating role; a central bank could have bailed out and reorganized the banks or even supplied public funding to some of the railroads.) No matter how much public funding the railroads received, such funding was not enough to effect public ownership; by 1850, US railroad firms—even those initially administered by the state—were predominantly privately owned and privately operated.[95]

Even during this early stage in their history railroads were faster, more direct, cheaper to maintain, and more predictable than canals, easily surpassing them as a superior form of transportation and enjoying "swift commercial success."[96] As demand for railroad transport increased, so did the scope of the lines and the scale of the firms managing them. Such growth, in turn, increased the dangers of mismanaged coordination, making the aforementioned organizational changes all the more imperative. Thus during this boom of the 1850s and 1860s, railroad managers "invented nearly all of the basic techniques of modern accounting" and business organization.[97] Procedures evolved so rapidly that, as Chandler states, "the American businessman of 1840 would find the environment of 15th-century Italy more familiar than that of his own nation 70 years later."[98] From 1850 to 1870, railroads thus emerged as the first modern business enterprise, with the 1850s considered a time of "building and learning to manage," and the 1860s and 1870s of "coordinating and competing for the flows of through traffic."[99]

[91] Ibid., 91.

[92] Alfred D. Chandler, Jr., "Patterns of American Railroad Finance, 1830–50," *The Business History Review* 28, no. 3 (September 1954), 263; Chandler, *The Visible Hand*, 92.

[93] Tindall and Shi, *America: A Narrative History*, 841.

[94] Perrow, *Organizing America*, 116.

[95] Chandler, *The Visible Hand.* 82.

[96] Ibid., 82–83.

[97] Ibid., 117.

[98] Ibid., 455.

[99] Ibid., 145.

Other industries would follow suit, adopting the modern, functionally organized, business model first pioneered by textile firms and then developed by railroad firms. Such industries included coal, iron, and steel—all of which were, unsurprisingly, directly involved in the operation of the railroads. Coal, for example, fueled the railroads and the factories whose products the railroads transported and consumed.[100] Between 1850 and 1870, the railroad industry thus led the way in developing the private nature and hierarchical structure characterizing managerial capitalism.

Giants Competing in an Unregulated Common: The Institutional Infighting of the Railroad Industry

In the years leading up to the 1870s the railroad industry in the United States laid the groundwork for the advent of modern managerial capitalism and a true national market. By 1869, the transcontinental railroad was completed, creating the backbone for the national transportation system; the United States' major transportation and communication systems were laid out and organized in that period, and the organizational methods that railroad managers implemented—most notably, hierarchy and functional integration—spread to other firms over the next three decades.[101] With the larger market of the time came much longer railroads, larger firms, and larger accumulations of economic power. Alfred Chandler observed: "the great railway systems were by the 1890s the largest business enterprises not only in the United States but also in the world . . . No public enterprise, either, came close to the railroad in size and complexity of operation. In the 1890s a single railroad system managed more men and handled more funds and transactions and used more capital than the most complex of American governmental or military organizations."[102] They simply dwarfed the power of individual state governments.

The enormity of the industry was apparent by the 1870s and 1880s. Railroads that had been at most 300 miles in length grew to giant systems of 5,000 to 10,000 miles, while the firms managing them grew accordingly.[103] Chandler notes such growth in the length, administration, and import of railroads at this time: "By the 1870s the large railroads of over 500 miles in length had perfected complex and intricate mechanisms to coordinate and control the work of thousands of employees, the operations of tens of millions of dollars' worth of roadbed and equipment, and the movement of hundreds of millions of dollars' worth of goods."[104] The US railroad industry, along with the hierarchical practices of the modern business enterprise, had effectively come of age.

[100] Ibid., 245.
[101] Ibid., 208.
[102] Ibid., 204.
[103] Ibid., 134.
[104] Ibid., 88.

Yet this was not the entire picture in 1870; eventual economic ruin and institutionalized inequality threatened the extraordinary expansion of the railroad industry. Over 70,000 miles of railroad track were in operation at this time, with many more miles under construction.[105] These miles of track were, however, no longer being laid with the enthusiasm for the early technology or to take advantage of land grants which were the main motives of the 1850s and 1860s.[106] By the late 19th century, the roads continued to expand rapidly, based not on transportation needs but on newly available capital from the nation's growing financial markets. Perrow notes that in the 1870s and 1880s, financiers poured money into railroad construction: "circumstances and interests created a pool of easily available capital that needed a place to go, and the railroads and their bankers were ready to provide that place."[107] Capital also came in the form of "enormous, but hidden, legal subsidies . . . brought about through changes in common law doctrines," as Horwitz explains.[108] Like Perrow, he points out that such support was by this time unnecessary and even excessive. "Though earlier grants of monopoly privileges may have been necessary in an underdeveloped society in order to promote private investment, the restrictive consequences of these grants were becoming apparent."[109] Firms channeled their easily obtained capital into unnecessary expansion, and took advantage of their risk-free and responsibility-free legal rights to further enhance profits, often at the expense of consumer welfare and industry efficiency.

Abundant capital from financiers and legal subsidies helped finance the railroads, but competitive pressures motivated railroad construction during the late 19th century. According to Chandler, "overbuilding was one consequence of the creation of the giant consolidated systems, the managers' response to increasing competition."[110] Spurred on by easy capital and tough competition, the expanding railroad industry soon became wasteful and ruinous, as "the great growth of the individual enterprises often led to a redundancy of facilities. During the 1880s more miles of track were built than in any other decade in American history, and in the 1890s more mileage was in bankruptcy than in any decade before or since."[111] Unsurprisingly, Perrow notes that "between 1875 and 1897, seven hundred railroad companies representing more than half the country's track went bankrupt."[112] The nationwide economic depression of 1873 no doubt also contributed to the number of bankruptcies, intensifying competition and worsening the effects of excessive expansion.[113] The railroad industry with

[105] Ibid.

[106] Ibid., 129.

[107] Perrow, *Organizing America*, 184, 186.

[108] Horwitz, *The Transformation of American Law, 1780–1860*, 100.

[109] Ibid., 130.

[110] Chandler, *The Visible Hand*, 88.

[111] Ibid., 147.

[112] Perrow, *Organizing America*, 209.

[113] Chandler, *The Visible Hand*, 136–137.

its innovative technology and managerial model had spiraled out of control; efforts to run a profitable business could not keep up with its endless expansionary efforts.

What exactly happened? According to Perrow, the legal rights granted by judicial adherents to the Free Contract Theory of the corporation and resultant liberal government (non)regulation of the industry—such as easily acquired general charters, the right to lock up capital indefinitely, limited liability laws, and the absence of any federal enforcement of regulations that were already in place—"meant substantial inefficiencies," overbuilding, and corruption.[114] New firms entered the industry to take advantage of lucrative land grants and eager investors; old firms laid down new, unnecessary track to retain or increase traffic; and few firms in either group faced government regulation of their economically wasteful ventures. In such a laissez-faire economic environment, many firms were even able to get away with "phony investment schemes" and "planned bankruptcies" to increase or maintain their miles of track, according to Perrow.[115] In fact, not only were these firms unregulated, but they were also able to manipulate the regulations that did exist; for example, Perrow notes that firm owners such as Commodore Vanderbilt and Jay Gould used their wealth to bid for political votes, purchasing political power in order to protect and enhance their firms' control over regions of track.[116]

Absent government regulation, the greatest pressure for controlling more routes by any of these means came from competition among the ever-growing number of firms. Yet, contrary to economic theory, competition did not lead automatically to rational use of resources. Lines faced high fixed costs—averaging two thirds of total costs in the 1880s[117]—that needed to be offset by income from a steady flow of traffic riding the lines.[118] Therefore, competition simply meant more and more building, without a mind to efficiency.

Chandler cites an increase in railroad mileage and consequent competition during the late 19th century, attributing it to efforts at integration. "By 1861 the American rail network was in no sense integrated . . . the major rivers did not yet have bridges. Roads entering the same terminal city had no direct rail connections. Roads used different gauges and different types of equipment . . . cars of one railroad could not be transferred to the track of another . . . As a result, transshipment costs were

[114]Perrow, *Organizing America*, 114.

[115]Ibid., 116.

[116]Ibid.,145; Here Perrow is citing several circulars and pamphlets published and publicly distributed during the late 19th century. He specifically relies on the work of Rufus Hatch, Henry Adams, and Charles Francis Adams, all of whom condemned the corrupt corporate practices of the railroad firms during their lifetimes, circa 1870s–1880s.

[117]Chandler, *The Visible Hand*, 134.

[118]Frank Dobbin and Timothy J. Dowd, "The Market that Antitrust Built: Public Policy, Private Coercion, and Railroad Acquisitions, 1825 to 1922,"*American Sociological Review* 65, no. 5 (October 2000), 634; Chandler, *The Visible Hand*, 134.

still high."[119] Subsequent efforts by firms to achieve uniform standards and connect interstate routes required inter-firm cooperation of the highest order. Chandler explains: "This type of cooperation between business enterprises was an entirely new phenomenon. The necessary standardization of equipment and operating procedures called for detailed and prolonged discussions among the managers of the many roads. They had to work out and then put into operation standardized operating procedures and equipment."[120]

Firms were highly successful in achieving such integration; by the 1880s a rail shipment could move from one part of the country to another without a single transsshipment."[121] However, the results of such coordination were not seen on the balance sheet. The volume of traffic on the interstate routes increased with their improved integration, similarly increasing firm competition for that traffic. Now that shipments and passengers could be passed from line to line with ease, firms had to fight to promote the use of their lines over others. Only by increasing traffic could they offset their high fixed costs, so "the volume of through traffic carried often made the difference between a road's financial success and failure."[122] Again, one thinks of the potential value of an external coordinating agent such as the Second Bank at this time; such an agent could have provided special funding to promote integration but also efficiency, serving a role like that played by J.P. Morgan in consolidating the steel industry.

But no such external coordinating force existed and inefficiencies abounded; the situation was unsustainable, and it fell upon the firms themselves to change it. As noted in my discussion of the early 19th century, initial business opposition to regulation plus Americans' inherited suspicion of political power had stymied the growth of regulatory powers among the states, while their enthusiasm for economic growth had endowed private firms with the power to innovate, expand, and in effect self-regulate. Consequently, in the 1870s when calls for the regulation of railroad competition became undeniable, it was the firms and not the state that responded. Unfortunately, they could not respond very effectively.

I do not mean to suggest here that the state was completely absent from the economic scene of the 1870s and 1880s. The state was present and active, for example, through the passage of laws by Congress and through the interpretation of those laws by the judiciary. Yet this involvement, however active, often ended up benefiting private interests to the detriment of the public interest, regardless of political or judicial intentions. One clear example is the Mining Law of 1872, signed by President Ulysses S. Grant. While the law did set rules for the mineral mining industry, these rules empowered more than restricted the actions of firms and its generous terms have, in fact, endured through the 20th century. According to the editorial board of the *New York Times*, the law continued to require "no royalties from the

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[119] Chandler, *The Visible Hand*, 122.

[120] Ibid., 123.

[121] Ibid.

[122] Ibid.

mining companies and contains no environmental safeguards, allowing mines to wreak havoc on water supplies and landscapes."[123] Such permissive legislation by the government at both the federal and state levels was not uncommon during the late 19th century. And as Horwitz notes, the negative externalities created by firms would be inflicted on the public as laissez-faire economic policies effectively put the "burden of economic development on the weakest and least active elements in the population."[124]

A similar pro-business trend emerged within the realm of law enforcement, as illustrated by the 1886 Supreme Court case of *Santa Clara County v. Southern Pacific Railroad Company*.[125] Chief Justice Morrison R. Waite's majority opinion in this case officially granted the corporation all the rights of personhood laid out in the first section of the Fourteenth Amendment, which stipulates that: "nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." Although this language appeared quite sweeping, the amendment was originally passed to protect the rights of newly emancipated African Americans from persecution by the southern states, and the amendment was interpreted rather narrowly to avoid undue federal interference in state government.[126] Despite progressive interpretations of the Court's decision, Horwitz argues, it was not a blatant promotion of business interests.[127] The majority of the justices were quite conservative and still adhered to the Free Contract Theory, equating a corporation with the aggregate of its shareholders; accordingly, the decision was meant to extend the equal protection clause on behalf of these shareholders.[128] Corporations were undoubtedly empowered by the *Santa Clara* ruling, employing it to further free business from state regulation; in fact, by this time the "Entity Theory" was emerging—a new model interpreting corporations to be individuals unto themselves, separate from not only the state but also their shareholders.[129] But as Horwitz argues, Justice Waite's majority opinion did not represent this new theory, despite appearances to the contrary. Waite's lack of an explicit reason for extending the Equal Protection Clause likely contributed to later misinterpretations of the Court's intent: "the Court does not wish to hear argument on the question whether the provision of the Fourteenth Amendment to the Constitution, which forbids a state to deny to

[123] Editorial Board, "Unchanged (for the Worse) Since 1872," *The New York Times*, August 20, 2007.

[124] Horwitz, *The Transformation of American Law, 1780–1860*, 101.

[125] 118 U.S. 394.

[126] Morton Horwitz, "Santa Clara Revisited: The Development of Corporate Theory," *West Virginia Law Review* 88, no. 173 (1985/1986): 177.

[127] Horwitz, *The Transformation of American Law, 1870–1960*, 79.

[128] Ibid., 70.

[129] Ibid., 73–74.

any person within its jurisdiction the equal protection of the laws, applies to these corporations. We are all of the opinion that it does."[130]

Historian Maury Klein offers a similar interpretation of the Supreme Court's ruling. Instead of creating a new theory defining the corporation, the Court simply tried to integrate the notion of the corporation into existing and well-established legal theory, namely, the Fourteenth Amendment.

> In trying to grasp the nature of corporations, Americans resorted to their traditional habit of casting unfamiliar things in some familiar form. Rather than adjust their beliefs to accommodate this new entity, they tried at first to fit it into existing ideology. The Supreme Court took this approach in a series of cases beginning in 1873 by defining the corporation as an individual in the eyes of the law and therefore entitled to all the protection guaranteed individuals under the Fourteenth Amendment. In effect the Court wrote myth into law, yet to have done otherwise would have compelled the justices to redefine traditional concepts of property rights and the proper role of government in economic affairs. No court was willing to undertake that radical task, especially at a time when the prevailing mood was to maximize the range of individual action. Moreover, few people during the 1870s anticipated the role that corporations would come to play in American life. By the 1900s, however, the chance had become painfully evident. "It is manifest," wrote Woodrow Wilson in 1907, "that we must adjust our legal and political principles to a new set of conditions which involve the whole moral and economic makeup of our economic life."[131]

But that was much more easily said than done, as we will see later in this chapter.

Whatever might have been the Court's motive behind the *Santa Clara* ruling, the ruling's interpretation of the Fourteenth Amendment tacitly permitted the major railroads to concentrate power by purchasing other firms as "property" during the next two decades. As Beatty notes, the Court's guarantee of corporations' Fourteenth Amendment rights in *Santa Clara* was a pivotal turning point; although "state courts had long 'presumed' public corporations to be 'freemen' or 'persons' . . . private corporations did not seek that status until the Fourteenth Amendment made being a person worthwhile."[132] More specifically, as early as 1805, certain states had guaranteed the "natural rights" of *public* corporations as "persons," but it was not until after the passage of the Fourteenth Amendment that this right was pursued by and extended to *private* corporations.[133] As Perrow notes, legal personhood gave corporations "the power to do things that individuals could do, including owning stock in other companies."[134] The Pennsylvania Railroad Company and later the state of New Jersey would take advantage of this newly affirmed corporate right, opening the possibility for a new strategy of consolidation.

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[130] *County of Santa Clara vs. Southern Pacific RR Co*. 118 US 392 (1886).

[131] Maury Klein, *The Genesis of Industrial America, 1870–1920* (New York: Cambridge University Press, 2007), 133.

[132] Beatty, *Age of Betrayal*, 163.

[133] Howard Jay Graham, *Everyman's Constitution: Historical Essays on the 14th Amendment, "The Conspiracy Theory," and American Constitutionalism (*Madison, WI: State Historical Society of Wisconsin, 1968), 378.

[134] Perrow, *Organizing America*, 210.

With the state effectively unable to curb the brutal competition and no federal vehicle such as the Second National Bank to help organize and orchestrate a collective response, bankruptcies plagued the railroad industry in the late 19th century and the firms themselves had to search for a solution. The strategy initially arrived at was cooperation through cartels, or formal federations of railroad firms whose boards would agree upon uniform rates.[135] However, since the temptation to undermine these standards to lure traffic was too great, and since cartel agreements were not enforceable through the courts, "by 1884 nearly all the railroad managers and most investors agreed that even the most carefully devised cartels were unable to control competition."[136] Competition was costly and cooperation was unviable; firms consequently turned to consolidation to achieve financial stability. The most successful form of consolidation was system-building, the merging of major lines through a majority purchase of stock; its goal was to guarantee a profitable "flow of freight and passengers . . . by fully controlling connections with major sources of traffic."[137]

The activities of the Erie and the Pennsylvania Railroads in the 1870s and 1880s illustrate this defensive strategy to combat competition, in this case by Jay Gould, owner of the Erie. As Gould's growing network drew traffic away from the Pennsylvania Railroad, J. Edgar Thomson, manager of the Pennsylvania, chose to fight back through system-building.[138] Besides countering Gould, Thompson's ultimate goal was for "the Pennsylvania Company to control its unified system between the Atlantic coast, the Great Lakes, and the Mississippi River."[139] To do so, the firm would have to buy a stake in railroads already connecting these routes, taking advantage of the rights of personhood upheld by the *Santa Clara* decision. According to Perrow, by citing the Fourteenth Amendment argument and "bribing Pennsylvania legislators," the Pennsylvania Railroad was able "to obtain legal permission to hold shares in other railroads, setting the stage for mergers in railroads, and industry in general at the end of the century."[140] Thomson's Pennsylvania was the first railroad firm to pursue this consolidation strategy successfully and Gould's Erie campaign ultimately failed.[141] As Chandler states, "in less than five years the Pennsylvania had grown from a line of 491 miles of track to one of just under 6,000 miles, or 8% of the total mileage of railroads operated in the United States."[142]

This strategy of consolidation or system-building would be quickly adopted by other firms over the next few years in their own defensive need to connect major commercial centers across the nation—without relying on the lines of rival

[135] Chandler, *The Visible Hand*, 137.
[136] Ibid., 142.
[137] Ibid., 147.
[138] Ibid., 151.
[139] Ibid., 155.
[140] Perrow, *Organizing America*, 142.
[141] Chandler, *The Visible Hand*, 150.
[142] Ibid., 151.

railroads—and thereby remain competitive.[143] Facilitating this process was the state of New Jersey and its legalization of the holding company in 1888. The concept of the holding company was essentially intended to justify buying the stock of other companies in order to exert significant owner influence over them or at least share in their profits. In fact, according to Prechel, it only "emerged because it was a legal means to pursue industrial consolidation strategies."[144] Previously, a firm could exercise its corporate privileges only within the state in which it was incorporated; purchasing rival firms incorporated within other states was prohibited by the laws of those other states. As the case of Pennsylvania Railroad's unofficial holding company shows, a strategy of acquisition could facilitate both growth and concentration. Such a strategy would require less capital, incur fewer liabilities, and enjoy returns on the stock of previous competitors so that there would be less of a need to reduce rates and therefore profits.[145] Until the case of New Jersey no state legislature had legally sanctioned the acquisition of corporations across state lines, generally viewing the strategy as a dangerous means of consolidating corporate power. Under pressure to finance its ever-increasing budget deficit, the New Jersey legislature overlooked such arguments and legalized the holding company for firms opting to incorporate there.[146] Horwitz notes that business interests may have played a role in prompting this move; corporate lawyers such as William Nelson Cromwell directly helped state legislators with the drafting of the law during 1889–1890.[147] From the state's point of view, the initiative was immediately successful: "Firms rushed to New Jersey; the state was able to avoid income taxes because the revenues from the incorporation business were so great."[148] In fact, the inflow of new firms and new capital was so immense that according to political economist Harold W. Stoke, by 1902 "the entire state debt, which had been one of the motives for this wholesale chartering business, had been wiped out."[149]

Beyond fixing the state's budget, the New Jersey statute carried far-reaching implications. As Stoke observes, New Jersey imposed little regulation upon the new holding companies which could consolidate companies and economic influence free from government oversight.[150] Other states objected to such a liberal law and the concentration of power that it encouraged. Yet as Stoke points out, "while most of the states strongly condemned the attitude of New Jersey toward the corporations, it was to be expected that some of them should grow envious of her large

[143] Ibid., 155, 88.

[144] Harland Prechel, *Big Business and the State: Historical Transitions and Corporate Transformation, 1880s–1990s* (Albany: State University of New York Press, 2000), 78.

[145] Perrow, *Organizing America*, 209.

[146] Harold W. Stoke, "Economic Influences Upon the Corporation Laws of New Jersey," *The Journal of Political Economy* 38, no. 5 (October 1930): 571.

[147] Horwitz, *The Transformation of American Law, 1870–1960*, 83.

[148] Perrow, *Organizing America*, 211.

[149] Stoke, "Economic Influences Upon the Corporation Laws of New Jersey," 575.

[150] Ibid., 570.

income, and should undertake to duplicate her program."[151] States were racing to the bottom once again, just as with the adoption of more flexible charters much earlier in the century. Justice Brandeis retrospectively noted the case of New York as particularly illustrative of this phenomenon: "The New York revision of 1890, which eliminated the maximum limitation on authorized capital and permitted inter-corporate stockholding in a limited class of cases, was passed after a migration of incorporation from New York, attracted by the more liberal incorporation laws of New Jersey."[152] Corporations flocked to New Jersey throughout the 1890s; according to Perrow, "by 1901, 66% of the U.S. firms with $10 million in capital or more, and 71% of those with $25 million or more, were incorporated in New Jersey."[153] Prechel confirms the incredible impact of New Jersey's law upon the corporate sector: "Between 1895 and 1904, 79.1% of the total capital consolidation in the U.S. occurred in New Jersey."[154] Over the next decade or so, large corporations and their capital would eventually migrate to New York and other states that followed New Jersey's opportunistic lead.

As the century came to a close, high fixed costs, cutthroat competition, and bankruptcies—the principal problems faced by railroad firms during the 1870s and 1880s—were somewhat curbed through consolidation. Cooperation had not worked; as Chandler notes, cooperative ventures "formed to control competition or to profit from the process of merger itself often brought short-term gains. But they rarely assured long-term profits."[155] On the other hand, consolidation through system-building seemed to work, particularly in the case of the Pennsylvania Railroad. Later efforts to consolidate through state-sanctioned means, such as through the holding company, appear to have been the most widely adopted. In fact, consolidations increased at an unprecedented rate; Prechel notes that "the number of corporations that disappeared due to mergers increased from 26 in 1896 to 69 in 1897 to 303 in 1898 to 1,207 in 1899. For the next 3 years (1900–1902), the number of mergers averaged 378 per year. There were 3,653 mergers between 1898 and 1902, 25 times the number in the succeeding 5 years. Most important, more than 50% of the consolidations resulted in a market share of over 40% for the new corporation. At least one third resulted in a market share of 70%. Between 1895 and 1904, 157 holding companies consolidated more than 1,800 firms and controlled more than 40% of the capital invested in the entire industrial sector."[156] Despite the relative success of all these consolidations, as the century came to a close, competitive pressures were ever-present and intensified as industry influence was increasingly concentrated in the hands of a few very large and very powerful firms.

[151] Ibid., 575.

[152] Justice Louis Brandeis, in *Ligget vs. Lee* 288 U.S. 517, 560–561 (1933).

[153] Perrow, *Organizing America*, 211.

[154] Prechel, *Big Business and the State*, 64.

[155] Chandler, *The Visible Hand*, 338.

[156] Prechel, *Big Business and the State*, 64.

1880–1900: Institutionalized Oligarchy and the Beginnings of Reform

The final decades of the 19th century witnessed a surge in corruption as well as corporate consolidation. Perrow suggests that the railroad industry was, in fact, shaped by selfish, shady practices: "Because corruption was so easy for the railroad system, due to the weak state and the vital nature of its product, the system was not shaped as much by efficiency considerations … as by opportunities in illegal and unethical gain."[157] Opportunities to gain from inefficient projects, from purchasing political power,[158] and from what Perrow calls "financial heists"[159] became all the more evident as firms grew in size and power leading to objections by state officials, private investors, and the public. State and federal governments aimed to regulate great concentrations of firm power, both through their legislatures and their respective courts. Key financiers tried not to control but at least to profit from such firm power by actively assisting in consolidation. Even the public spoke up; average employees and Progressive and Populist leaders attempted to undermine railroad interests through strikes and radical reforms. The late 19th century thus witnessed a variety of challenges to—though not always victories over—the powerful position of corporations within modern managerial capitalism, a system by this time almost institutionalized within the American economy, according to Perrow.[160]

State Action Against the Concentration of Corporate Power

The US government generally did not pursue a policy of regulating the railroad industry—or any major industry for that matter—as it developed during the 19th century. Engerman and Sokoloff confirm this predominantly laissez-faire policy: "Throughout most of the 19th century the government played a role in influencing industrial growth, to a great extent by providing positive incentives. It was only at the end of the century that the government added widespread regulation to promotion."[161] Until the turn of the century even, effective regulation was relatively futile; as sociologist John R. Commons explained to fellow Progressives at the time, state and federal agencies could be "easily swayed by special interests—by private corporations, political organizations and trades unions, which hold the balance

[157] Perrow, *Organizing America*, 143.
[158] Ibid., 145.
[159] Ibid., 116.
[160] Ibid., 3.
[161] Stanley L. Engerman and Kenneth L. Sokoloff, "Technology and Industrialization, 1790–1914," in *The Cambridge Economic History of the United States*, vol. 2: The Long Nineteenth Century, ed. Stanley L. Engermand and Robert E. Gallman (Cambridge: Cambridge University Press, 2000), 392.

of power through their control of wealth or votes."[162] Corporate consolidations and corresponding accumulations of economic power became impossible to ignore; after almost a century of relative inaction, government agencies responded at both the state and federal levels.

California provides a very important example of how corporate capitalism could lead to concentrated power that was transferred from the economy to the polity and back, all for private advantage. Through the system-building schemes of the "Big Four" railroad managers—Collis Huntington, Leland Stanford, Charles Crocker, and Mark Hopkins—"the Southern Pacific had established a complete monopoly of rails in California by the 1870s."[163] In the decades to follow, according to Spencer C. Olin, the corporation then "entered politics to preserve its monopoly and to extend its influence throughout the state."[164] Primary on the Southern Pacific's agenda was ensuring that freight and passenger rates were set at a highly profitable level. Shippers and passengers naturally objected to the firm's monopolistic price setting, so in September 1878, the California legislature came together in a constitutional convention to address the issue. As historian Ward McAffee explains, "the convention decided to charge a three-man railroad commission with the power to set maximum rates," a decision unprecedented by any other state's constitution.[165] Yet these regulatory efforts proved futile; the railroad interests simply held too much sway over the Committee and California politicians in general. As Olin explains, throughout the 1880s "the Southern Pacific concentrated its manipulative efforts on the members of the newly created Railroad Commission and thereby successfully prevented rate reductions."[166] In order to set rates deemed reasonable by passengers, shippers, and railroad firms, the Commission had to assess the value of railroad property in the state. However, the Southern Pacific, through its great political influence, was able to prevent or manipulate such evaluations by limiting the Commission's operating budget.[167] It used its economic clout to control which politicians were in power, and by directing the committee. Olin describes this process: "all candidates for public office were nominated by partisan conventions. The Southern Pacific usually controlled these conventions by means of its notorious Political Bureau . . . [which] was primarily an institution that used politics for business ends . . . its sole raison d'être was to ensure that the company would not have to pay its share of the tax burden, would escape state and local regulation, and could expand its system unhampered by outside influence."[168] Not only

[162] John R. Commons, "Referendum and Initiative in City Government," *Political Science Quarterly* 17, no. 4 (December 1902), 625.

[163] Spencer C. Olin, Jr., *California's Prodigal Sons* (Berkeley: University of California Press, 1968), 1.

[164] Ibid.

[165] Ward McAfee, *California's Railroad Era 1850–1911* (San Marino, CA: Golden West Books, 1973), 166–167.

[166] Olin, *California's Prodigal Sons*, 2.

[167] Ibid., 15.

[168] Ibid., 3.

the creators but also the enforcers of railroad rates operated under the influence of the Southern Pacific. According to Olin, "the state Supreme Court, bound by legal precedent and possibly susceptible to Southern Pacific machinations, decided fifty-seven of seventy-nine cases in the company's favor from 1895 to 1910."[169]

The political power of railroad firms was similarly apparent at the federal level, within the administrative agencies and the courts. The Interstate Commerce Commission and the Sherman Anti-Trust Act illustrate the challenges of achieving accountability at the federal level. Although the ICC was established by the Interstate Commerce Act in 1887 to prevent further consolidation of corporate power via monopolistic rate setting, the commission in effect protected it, at least initially. Like the Californian commission, the ICC was responsible for setting reasonable rates and forcing firms to stick to them. Yet the law under which the ICC operated was worded vaguely, leaving much room for interpretation in the railroads' interest.[170] Moreover, the first chairman of the ICC, Thomas M. Cooley, was a strong sympathizer of the railroad industry. One of the very first cases the ICC decided under Cooley's leadership—*Louisville and Nashville R.R. Co., 1, ICC 31, 1887*—effectively freed the railroads from Section Four of the Act, which specified that short hauls could not be priced higher than long hauls along the same path; this case set a precedent for allowing "railroads to suspend section four when it hurt them and maintain it when it was to their benefit."[171] Such cases were not an exception in decisions by Cooley and the Commission. According to historian Gabriel Kolko, even when Chairman William R. Morrison took over the ICC between 1891 and 1897, the members of the ICC still "continued many of their older informal relations with railroads, some of which were clearly illegal".[172] Just as in California, railroad interests as a whole had accumulated enough political power by the late 19th century to effectively influence the positions and decisions of federal politicians.

Not until 1911 or so would railroad interests be removed from their position of economic and political power within the state.[173] At this time, progressive politician Hiram Johnson was elected governor and immediately secured passage of legislation to undermine the Southern Pacific's political control over state politics, particularly the Railroad Commission.[174] Johnson's Stetson-Eshleman bill finally enabled the Commission to establish and enforce rates based on railroad property values by formally reasserting as well as funding its efforts to "ascertain the actual value of all property owned by transportation companies within the state."[175] After years of

[169] Ibid., 3.

[170] Gabriel Kolko, *Railroads and Regulation, 1877–1916* (Princeton: Princeton University Press, 1965), 49.

[171] Ibid., 51.

[172] Ibid., 68.

[173] Olin, *California's Prodigal Sons*, 2.

[174] Ibid., 35.

[175] Ibid., 37.

almost monopolistic power, railroad interests were finally made accountable to the laws of the state of California.

The federal courts provided an important mechanism to exercise the regulatory powers of the federal government, and the Sherman Antitrust Act of 1890 seemed to give them the power they needed. The act formally "declared illegal restraints on interstate commerce and combinations in the form of trusts or otherwise in restraint of trade."[176] Like the act establishing the ICC, the wording seemed straightforward but its meaning was immediately challenged; what exactly qualified as "restraint of trade"? According to Dobbin and Dowd, railroad firms were able to use this vagueness to their advantage, continuing consolidation through horizontal mergers and holding companies that were technically not trusts but effectively operated to the same ends of profit and power.[177] And in the rare case that railroads did end up being brought to trial for infringing upon the clauses of the Sherman Act, they won "15 of the first 16 rate cases that reached the Supreme Court."[178] Notably, the Court interpreted the Act's "restraint of trade" clause more strictly when reviewing suits brought by businessmen against striking, unionized workers. For instance, in the 1895 case of *In re Debs* (158 US 564, 1895), the Court ruled that the federal government had the right to order an injunction against any union whose actions restrained or interfered with interstate commerce, the exclusive domain of the federal government; the ruling was specifically related to the legitimacy of past federal intervention against those workers engaged in the Pullman Strike of 1894.[179] Martin J. Sklar explains that, as illustrated by this case and others, the Sherman Act actually "posed an incomparably greater threat to labor than to capital. By and large, the Sherman Act might affect the personal security of capitalists, or their business entities or practices, only as and when the federal government brought suit. But without government action at all, employers could bring Sherman Act cases for treble damages against unions and, with the injunction, attain instant relief for themselves and swift retribution or destruction to the unions."[180] In this way, the Sherman Act was in practice quite favorable to business interests; its vague clauses made it relatively easy for corporate lawyers to argue against or for its application, whichever would best suit their clients, while its federal enforcement structure made it easy for employers to escape the notice of the (by then) weak federal agencies, on the one hand, and to bring attention to employees' alleged infractions, on the other.

The government's lack of legal clout against the concentration of corporate power stemmed not only from corporate lawyers who took advantage of the above vaguely worded regulations, but also from the highest federal judges who held

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[176]Prechel, *Big Business and the State*, 61–62.

[177]Dobbin and Dowd. "How Policy Shapes Competition," 502, 504.

[178]Dobbin and Dowd, "The Market that Antitrust Built," 653.

[179]Duncan Kennedy, "Toward an Historical Understanding of Legal Consciousness: The Case of Classical Legal Thought in America, 1850–1940," in *Essays on Adjudication, 1973–2004*, 2004, 15.

[180]Martin J. Sklar, *The Corporate Reconstruction of American Capitalism, 1890–1916: The Market, the Law, and Politics* (Cambridge: Cambridge University Press, 1988), 225–226.

to a conservative, free-market mentality. At this stage, judges generally viewed corporations not as aggregates of shareholders but as independent beings under the "Entity Theory."[181] In the same laissez-faire vein they had retained the doctrines of Classical Legal Thought, which adhered to the notion that the only legitimate economic policy is one that invariably allows free-market competition; any regulation that would result in a redistribution of economic power—even if the existing distribution created great, "unjust" inequalities—was unlawful.[182] As Duncan Kennedy, a Harvard law professor and the coiner of the term Classical Legal Thought, explains: "Classical legal thought supported the classical economists' claim that the outcome of economic processes was 'natural'"[183] and thus the corresponding notion that "equality does not figure among the legitimate goals of the legal system."[184] Legal actors in this way joined economists in defending the free and purportedly fair market, preventing political actors from altering the economic (and thus social) status quo. As a result, even when the major railroad firms engaged in predatory practices (such as rate setting, wage reductions, and industry acquisitions) publicly and politically recognized to be at the expense of consumers and laborers, "federal administrative regulation [still] met regular and persistent judicial efforts to confine its scope and limit its powers," as Horwitz explains.[185] Horwitz cites the 1905 case of *Lochner v. New York*[186] as illustrative of the peak of such laissez-faire rulings by the Supreme Court.[187] Put simply, the case involved a New York state law that prohibited bakers from working over 60 h a week. The measure was attacked by the Lochner bakery company, as a violation of its right to a free contract with its employees. Lawyers representing the State of New York defended the law on the grounds that it protected the health of the bakers, and therefore fell within the legal bounds of state action. Wary of any government interference within the economy, the Supreme Court rejected this reasoning and struck down the law. The majority opinion, written by Justice Rufus Peckham, explained first that the long workweek was not a threat to the health of bakers, and second that the law was, in fact, an act of redistribution, of taking away the property of bakers and their managers, and of infringing upon their right to free contract.[188] The *Lochner* decision formally prioritized the freedom of contract relative to public policy concerns and set up another roadblock to government regulation of corporations.[189] Such regulation was already rendered illegitimate by the justices' belief in Classical Legal

[181] Horwitz, *The Transformation of American Law, 1870–1960*, 73–74.

[182] Ibid., 194.

[183] Duncan Kennedy, "The Role of Law in Economic Thought: Essays on the Fetishism of Commodities," *American University Law Review* 34, no. 4 (Summer 1985), 956.

[184] Ibid., 957.

[185] Horwitz, *The Transformation of American Law, 1870–1960*, 214.

[186] 198 U.S. 45.

[187] Horwitz, *The Transformation of American Law, 1870–1960*, 193.

[188] Ibid., 29–30.

[189] Ibid., 33, 35.

Theory; after *Lochner* it was further rendered unconstitutional. The state, particularly at the federal level, could not effectively halt the growth of corporate power until the restrictions placed on it by contemporary interpretations of the Constitution were overturned. Such a reversal would not come until the 1930s, when Franklin Delano Roosevelt's New Deal challenged the legitimacy of the nine members of the Supreme Court to systematically overrule the Congress of the United States.

Wall Street's Action Against the Concentration of Corporate Power

Financiers also responded to the increasing consolidation of firm power within the railroad industry between 1880 and 1900. Unlike the state, Wall Street investors were in favor of such consolidation, as long as they had a hand in it. Put simply, competition through rate wars put many of the firms in which they had invested out of business, while consolidation yielded at least some return on their investments. By the 1890s, Dobbin states, the major bankers financing the railroads "announced that they would not countenance predation, and in particular they would refuse capital for the practice of competitive building . . . [they] would punish roads that practiced predation."[190] Financiers thus took an active role in encouraging and even arranging the railroad consolidations of the late 19th century.

Exemplary of these bankers was J.P. Morgan, a well-known financier and the unofficial leader of Wall Street banks in the late 19th century. On January 8, 1889, Morgan called a meeting with the major railroad barons of the time, ostensibly to discuss ways around the barriers to cooperation. In order to circumvent federal efforts to curb consolidation—such as the ICC and the Sherman Anti-trust Act, above—Morgan proposed forming a commission of railroad leaders who would together organize rates and the industry in general.[191] While the commission itself was unsuccessful, Morgan's involvement and personal investments led to a massive consolidation of the railroad industry. By the late 1890s, Morgan's investment house became "the most important factor in the railroad sector of the economy, controlling" major lines such as the Erie, the Philadelphia & Reading, the Northern Pacific, the Southern Pacific, and more.[192] Power was therefore further concentrated in the industry with Morgan's aid, wielded now both by managers and by Morgan himself. As Charles R. Geisst explains: "The railroads' constant infighting presented a window of opportunity for someone who possessed what they did not: access to large amounts of capital and the diplomatic skills to match, a necessity when dealing with the states and the federal government. Morgan recognized the

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[190] Dobbin and Dowd. "The Market that Antitrust Built," 638.

[191] Charles R. Geisst, *Monopolies in America: Empire Builders and Their Enemies from Jay Gould to Bill Gates* (Oxford: Oxford University Press, 2000), 36.

[192] Kolko, *Railroads and Regulation*, 65–66; Perrow, *Organizing America*, 216.

capital problems surrounding the railroad industry and realized that whoever ultimately controlled the capital flows effectively controlled the railroads."[193] Perrow joins Geisst in asserting that Morgan knew what he was doing in encouraging consolidation; major Wall Street financiers like him were less concerned with creating an efficient intra-industry structure than in "seeing that their much larger interests in a few big firms were protected and extended. Promoting consolidation would not only do that, but increase their wealth and power by centralizing the system in their hands."[194] (Again, I note that the existence of a Second National Bank might have allowed a different vehicle through which to guide reorganization of the industry, perhaps into smaller regionally based units.)

Public Action Against the Concentration of Corporate Power

Discouraged by failed attempts by state and federal agencies to counter the ever-increasing concentration of power of corporations, particularly the railroads, the public itself took action during the final years of the 19th century. Three significant groups of actors emerged: firm employees, the Populists, and the Progressive reformers. Workers and activists fought back through union-led strikes; the latter two through political organization and proposals for reform.

By the 1880s, at least 84 of the largest railroad firms employed over 1,000 workers each; if properly organized these employees could challenge corporate interests.[195] The strike was the method of choice for these and other workers in major industrial firms of the time, often organized by unions. The Great Railroad Strike of 1877, the Haymarket Strike of 1886, the Homestead Lockout of 1892, and the Pullman Strike of 1894 were among the most notable strikes of the late 19th century, in the railroad and steel industries. Each one stemmed from a pattern of extreme working conditions, up to 72 h work per week with pay cuts and the punishment of outspoken workers. Massive strikes were followed by the mobilization of political, legal, and military officials by the firms involved; they were determined to overcome the strikes with intense anti-labor propaganda and violence, often resulting in significant injuries and deaths on both sides. The Pullman Strike of 1894 illustrates this pattern, demonstrating both the initiative taken by average workers and the collusion of the state with corporate interests.

Perhaps the most notable episode of state collusion with corporate interests was the response to the Pullman strike organized by the American Railway Union. When the workers went on strike, the Pullman Company's initial response was to wait and starve out the strikers in Pullman town.[196] But by the end of June 1894 the strike

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[193]Geisst, *Monopolies in America*, 33–34.

[194]Perrow, *Organizing America*, 201.

[195]Ibid., 180.

[196]Samuel Yellen, *American Labor Struggles: 1877–1934* (New York: Pathfinder Press, 1936), 111.

spread to an all-out boycott, affecting operations in several major cities including Minneapolis, St. Louis, San Francisco, Denver, and Chicago; "the country had never before seen a strike so well organized on so large a scale."[197] The company responded in full force, using "every instrument of federal power except the navy to break the Pullman Strike of 1894."[198] Pullman first encouraged US Marshal J. W. Arnold to call out special federal deputies and then Illinois Governor John Peter Altgeld (who personally sided with the strikers and had objected to the presence of federal troops) to call out local militia; a total of 14,000 armed men entered the city, giving rise to street fighting on July 6 and July 7 during which the militia killed 20 to 30 persons.[199] In addition to sanctioning such violence, Pullman pursued the matter in court.[200] With his economic clout, Pullman was able to secure a federal injunction in clear favor of his and all large corporations' interests against workers. Not only were the strikes, picketing, and boycotting of the Pullman affair now effectively illegal,[201] but they were furthermore judged to be a form of "malicious conspiracy."[202] Soon after the court injunction, the strike began to deteriorate; the workers could not persevere in the face of such strong economic, military, and legal opposition. The Pullman Strike and its conclusion illustrated the power of big business when united with state politicians and the courts. Workers had little power to oppose the inequities they identified with modern managerial capitalism.

Workers were not alone in objecting to the power amassed by firms in the final decades of the 19th century. Joining them were the Populists and the Progressives, both of whom worked to radically alter the political system, convinced that it was too corrupted by corporate interests to counter them effectively. The two groups certainly differed. Briefly and generally put, the Populists were rural farmers, while Progressives were urban professionals; the Populists wanted to destroy corporations altogether and promote economic growth through increasing the money supply via the free coinage of silver, while the Progressives wanted to regulate and tax the firms.[203] Both groups pushed to reform the political system in order to undermine the power of corporations within it.

Both Populists and Progressives were shocked by the excessive influence wielded by the leaders of corporate capitalism, drawing condemning caricatures of "robber barons" such as Andrew Carnegie (the owner of Carnegie Steel), Jay Gould (the owner of the Erie and other western railroad systems), and J.P. Morgan. As historian

[197] Ibid., 116.

[198] Beatty, *Age of Betrayal*, 193.

[199] Yellen, *American Labor Struggles*, 117, 121–122.

[200] Ibid., 117.

[201] As noted previously in this chapter, the Pullman Strike ruling was only one of many cases in which the Supreme Court declared the organized efforts of labor to be illegal. From the 1890s to the 1930s, the Supreme Court frequently sided with employers who brought suit against unions for creating so-called "restraints of trade" in violation of the Sherman Antitrust Act of 1890.

[202] Yellen, *American Labor Struggles*, 125.

[203] Thomas E. Cronin, *Direct Democracy: The Politics of Initiative, Referendum, and Recall* (Cambridge: Harvard University Press, 1989), 43.

Charles A. Beard, quoting from their 1892 Party Platform, writes, the Populists went so far as to declare that "America was ruled by a plutocracy . . . that corruption dominated the ballot box, 'that the fruits of the toil of millions are boldly stolen to build up colossal fortunes for a few unprecedented in the history of mankind; and the possessors of these in turn despise the republic and endanger liberty.'"[204] For Populists and Progressives alike, just as deplorable as these "colossal fortunes" was the way in which they were put to use, corrupting public figures in order to maintain and even increase corporate power. Political scientist Thomas E. Cronin explains this translation of economic influence into political influence during the late 19th century well:

> representative institutions were severely tested in the 1890s because while our economic system was being transformed so also were the prizes and stakes involved in law-making and state policymaking. Legislatures had to make important decisions about the vital rights of railroads, lumber and mining interests, banks, and land speculators, not to mention decisions about the fate of social and welfare legislation. Not surprisingly, these vested interests sought the favorable verdict of state legislative officials and generally had resources with which to lobby the legislators.[205]

The political power wielded by special interests was evident not only to Populist and Progressive leaders, but also to the general public. According to Cronin, "public mistrust of state legislatures was considerable in the 1890s and at the turn of the century . . . Citizens were increasingly convinced that powerful, organized self-seeking interests shaped legislative outcomes at the expense of the public interest."[206]

Empowering Voters Through Direct Democracy

As representatives of the public interest, Populist party leaders and Progressive reformers believed reform was essential to counter the influence of special interests in the political system. Specifically, they worked to change the system from a representative democracy to a direct democracy, adopting procedures such as the initiative petition, the referendum, and the direct election of senators.[207] The first two would allow citizens to participate directly in politics, proposing and attempting to overturn state laws by direct voting.[208] The movement to promote direct democracy had some notable successes at the state level. In Oregon, for example, during its first few years the initiative was employed to address many of the issues to which reformers had objected; David Broder, a senior political writer for the Washington Post states that, "using the new tool, they levied the first serious taxes on railroads,

[204] Charles A. Beard and Mary Beard, *The Rise of American Civilization* (New York: The Macmillan Company, 1928), 209–210.

[205] Cronin, *Direct Democracy*, 55.

[206] Ibid., 54.

[207] Ibid., 44.

[208] Broder, *Democracy Derailed: Initiative Campaigns and the Power of Money*, 5, 34.

utilities, and other big companies; regulated freight rates; introduced a presidential primary and direct election of senators; gave women the right to vote; and instituted the eight-hour day and workers' compensation."[209] At the national level, reform was more difficult; as we shall see in the following section, it would take over 20 years for both the House and the Senate to pass the Seventeenth Amendment requiring the direct election of Senators.

In general, the majority of reforms presented during the 1890s and early 1900s struggled to gain ground. They required at least some support from government officials and the major political parties to pass into law, yet such support was difficult to acquire from these state actors as they appeared to be "under the influence of the railroads, trusts, and monopolies."[210] Historian John M. Allswang succinctly describes the futility of political reform in California, persisting through the early 20th century:

> The initiative, referendum, and recall continued to be introduced into subsequent sessions of the legislature, in 1905, 1907, and 1909, but with no effect. It appears that the Southern Pacific decisively turned against it, responding to the fact that the successful implementation of direct democracy in cities across the state was trumpeted by its proponents as a way to overthrow the railroad's influence. This was an important factor in legislators' actions, since the Southern Pacific did have the power to limit their advancement in the legislature.[211]

Reformers in other states faced similar challenges, and until the federally imposed reforms of the 1910s, the reign of corporate interests appeared inviolable. The most that reformers were able to achieve at the end of the 19th century was increased public awareness and a few minor regulations which, in Kloppenberg's words, "usually functioned as wrist slaps rather than effective long-term restraints on corporate power."[212]

Why was it so difficult to countervail corporate interests during the 19th century? Three intellectuals offer answers. By the end of the century consolidations had concentrated industry power in the hands of a few major corporations. Louis Brandeis, a reform-minded academic appointed by Woodrow Wilson to the Supreme Court, suggested that such great size not only curbed the prospects of competition, but also increased the risks of political influence: "size alone gives to giant corporations a social significance not attached ordinarily to smaller units of private enterprise. Through size, corporations, once merely an efficient tool employed by individuals in the conduct of private business have become an institution—an institution which has brought such concentration of economic power that so-called private corporations are sometimes able to dominate the state."[213] Perrow joined Brandeis in noting the overwhelming size and therefore

[209]Ibid., 37.

[210]Cronin, *Direct Democracy*, 44.

[211]John M. Allswang, *The Initiative and Referendum in California, 1898–1998* (Stanford, CA: Stanford University Press, 2000), 12.

[212]Kloppenberg, "Democracy," 175.

[213]Brandeis. *Ligget vs. Lee* 288 U.S. 517, 565 (1933).

power of private corporations, such as the Pennsylvania Railroad compared to the federal government. According to Perrow, "in 1891 the Pennsylvania Railroad employed over 110,000 workers. In the same year the total number of soldiers, sailors, and marines in the United States' armed services was 39,492. The Post Office, the largest government office in terms of employees, had 95,440 workers in 1891 ... in the United States, the railroad, not the government or the military, provided training in modern large-scale administration."[214] Furthermore, the state was small not only with respect to its manpower but also with respect to its financial power. As Prechel notes, "the Antitrust Division of the Department of Justice remained weak through the Taft and Wilson administration ... Until Franklin Roosevelt's presidency, the total budget of this part of the state structure remained below $1 million."[215] These three authors argue convincingly that corporate interests could not be effectively countered until federal representatives of the public interest approached and outgrew the private interests in terms of the size of their administration, budget, and/or regulatory powers.

1900–1930: Attempts to Establish More Adequate Federal Regulation of the National Market

A shift in the imbalance of power between private corporations and political agencies finally came in the 20th century, but not until the Depression of the 1930s when corporations were at their weakest. As Perrow explains, "the centralization of wealth and power increased in the nineteenth century as a result of the growth of large organizations. Not until the 1930s was it checked, as a result of steady, if mild, redistributive efforts over the next forty years by the federal government and by a variety of political and voluntary organizations."[216] Despite Perrow's critique of the efficacy of reforms between 1900 and 1930, these years nevertheless witnessed a notable increase of federal involvement in regulating corporate interests, especially between 1900 and 1913. Of particular note were the debates over federal incorporation powers and the direct election of US senators, as well as the ultimate establishment of a central bank through the Federal Reserve Act of 1913, granting the federal government a presence within the national economy which it had lacked ever since Jackson's veto of the Second National Bank over 80 years earlier. However, as Perrow and others (such as Gabriel Kolko and Charles Geisst) argue, the federal government would not come to rein in corporate interests and their excessive concentrations of power until the 1930s with the New Deal reforms of Franklin Delano Roosevelt and ultimately the wartime mobilization demands of World War II.

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[214] Chandler, *The Visible Hand*, 204–205.

[215] Prechel, *Big Business and the State*, 63.

[216] Perrow, *Organizing America*, 3.

Increasing Federal Regulatory Powers Over the National Market or Common

Between 1900 and 1930, the Progressives had some success in increasing federal regulatory powers over the national market. Specifically, they managed to get a series of federal laws passed to regulate railroads and other corporations, including the Hepburn Act of 1906, the Mann-Elkins Act of 1910, the Clayton Act of 1914, the Federal Trade Commission of 1915, the Federal Railroad Act of 1918, and the Transportation Act of 1920, among others. As impressive as this might seem, all of these attempts to increase regulatory oversight had to pass through the gauntlet of a Senate dominated by business interests, starting from the fact that Senators were chosen by state legislatures, many of which were dominated by those very business interests. In addition, a number of journalists, known as muckrakers, uncovered specific practices within the Senate which indicated the business-friendly traditions of that body. Thus, until there was reform *of* the Senate there was little chance of reform *by* the Senate or by the Federal government.

Despite the regulatory acts just noted, the major railroad firms of the early 20th century regarded federal regulation as a welcome alternative to more stringent regulation by the states. According to Kolko, "after 1900, the problem of state regulation became substantially more burdensome to the railroads. State taxes on railroads increased from $35 million in 1893 to $74 million in 1907 to $134 million in 1915. The average state taxes per mile of railroad, a better criterion, increased 71% from 1900 to 1910."[217] Railroad firms were subject not only to higher taxation by the states, but also to more restrictive maximum fare laws; "in 1902–1907, twenty-two maximum fare laws and nine maximum rate laws were passed by the states."[218] With state governments reducing their profits and dividend yields, the railroad industry was ready for new, ultimately weaker, regulation by the federal government.[219] Since the Constitution gave the federal government the exclusive power to regulate interstate commerce, its regulations superseded those of any state.

In 1906, Congress passed the Hepburn Act, which reasserted the authority of the Interstate Commerce Commission to establish maximum railroad rates. According to Geisst, "the Hepburn Act was designed to restore the commission to a central position in the fight against big business."[220] Yet, like the Sherman Act before it, the Hepburn Act was worded in such a way that the setting and enforcement of maximum railroad rates was at the discretion of individual politicians and judges, both of whom were potentially corrupted by corporate interests. Specifically, Kolko

[217] Kolko, *Railroads and Regulation*, 165.

[218] Ibid., 166.

[219] Ibid., 173.

[220] Geisst, *Monopolies in America*, 68.

explains, the Act gave the ICC the “authority to determine a rate, upon a complaint and hearing that was ‘just, fair, and reasonable’ without giving the slightest criterion of what those terms precisely meant.”[221] Furthermore, the Act gave the ICC no way of curbing monopolistic practices such as discrimination between short and long hauls.[222] In fact, the railroads welcomed the Hepburn Act as mild legislation that “did not threaten the end of their world,” while it freed them from strict state regulation.[223]

Presidents Theodore Roosevelt, William Howard Taft, and Woodrow Wilson at least nominally supported the Progressive agenda of increasing federal oversight of business interests, without actually threatening the latter’s economic dominance. Kolko notes this pattern arising as the federal government replaced state governments in the realm of railroad regulation: “by the end of Roosevelt’s presidency, the ICC had broken into a routinized pattern of adjudicating the problems of the railroad industry without concern for the larger interest of a public not immediately involved in the day-to-day issues preoccupying the railroads, Commission, and wealthier shippers.”[224] President Taft continued this trend, proposing and pushing through the Mann-Elkins Act of 1910, which Kolko describes as being no better than the Hepburn Act in articulating “a workable standard for ‘just and reasonable’ rates.”[225] Given the vague wording of these regulations and the pro-railroad judges, Taft appointed to the federal Commerce Court, it comes as no surprise that in 1911 alone, the court decided 27 out of 30 major cases in favor of railroad interests, continuing this pro-business trend until the Commerce Court was abolished by Congress in 1913.[226] Woodrow Wilson, despite his Progressive tendencies, also promoted ineffective federal regulations of business interests. Kolko explains that during Wilson’s administration, state regulations continued to aggravate railroad firms, with 42 state legislatures passing 230 railroad laws in 1913 alone.[227] Firms thus continued to welcome federal regulation, such as the Federal Railroad Control Act of 1918 and the Transportation Act of 1920, both of which were regarded as “victories” by the railroads; the latter actually permitted pooling, an oligopolistic activity that had been outlawed years earlier.[228] According to Kolko, the federal regulations passed during the Wilson administration were so hospitable to railroads that the ICC gained a “reputation of being the shield of the railroads against the public.”[229] Overall, his analysis shows that under the presidencies of

[221] Kolko, *Railraods and Regulation*, 151.
[222] Ibid., 152.
[223] Ibid., 135.
[224] Ibid., 168.
[225] Ibid., 193.
[226] Ibid., 199–201.
[227] Ibid., 217–218.
[228] Ibid., 229.
[229] Ibid., 229.

Roosevelt, Taft, and Wilson, the federal government replaced the states as the primary—albeit ineffective—regulator of railroad rates.[230]

As legal scholars such as Sklar[231] point out, the development of these nominal federal regulatory powers during the early decades of the 20th century was fundamentally determined by the Supreme Court. The Court had the final say on the scope and power of federal regulations and, in its application of the laissez-faire principles of Classical Legal Thought, arguably contributed to the regulatory inefficacies noted above. To explain: After 1890, the Court affirmed the constitutional power of the federal government to regulate the national market but to do so only through the Sherman Act, passed that year.[232] However, since the Court interpreted the Act through the lens of Classical Legal Thought, it often overruled government suits against businesses, finding the latter to exhibit "reasonable" restraints of trade best regulated by free market and not coercive government forces. Sklar explains: "The Court's position . . . was that Congress had, under the commerce clause of the constitution, full power to regulate interstate and foreign commerce, and to limit liberty to the extent thereby implied . . . in enacting the Sherman law, Congress had decided to retain exclusive power to regulate the interstate and foreign market . . .; and that for the duration, until it might decide otherwise, Congress had chosen to exercise its regulatory power through the hidden hand of unrestricted competition."[233] Put simply, while it nominally promoted federal regulation of the national market, the Court effectively undermined such regulation with its laissez-faire interpretation of actual cases. Thus, while Congress (influenced by political concerns and business lobbying) prevented strong, specific regulations from being enacted, the Court (influenced by the doctrine of limited state power) prevented even weak, vague regulations from being applied.

Not all efforts to increase federal oversight of the economy were undermined, however. As illustrated by the successful emergence of a central banking system during the early 20th century, federal policies were relatively effective in their passage and application when the interests of powerful actors were threatened. Following the Panic of 1907, the case was clear that the United States needed government regulation of the banking system. The panic threatened the interests of the powerful as well as those of smaller actors. Without a central bank regulating their actions, state banks and trust companies ended up lending without limits and without minimum capital requirements. Between 1897 and 1907 their capital ratios dropped from 28% to 19%.[234] This drop was encouraged by the credit needs of expanding industries and enthusiastic investors during those 10 years, and then proved fatal when the stock market crashed in 1907. However, with such strained cash reserves,

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[230]Ibid., 230.

[231]E.g., Morton Horwitz, Stephen Skowroneck, Justice Robert H. Jackson, and Martin J. Sklar.

[232]For more on the Sherman Antitrust Act of 1890, please refer to the earlier pages of this chapter.

[233]Sklar, *The Corporate Reconstruction of American Capitalism*, 169–170.

[234]Joseph French Johnson, "The Crisis and Panic of 1907," *Political Science Quarterly* 23, no. 3. (September 1908): 460.

banks were unable to satisfy depositors' demands for immediate cash and a panic ensued.[235]

After almost 80 years of inaction, government officials finally were forced to recognize the nation's need for the coordination, stability, and security that a central bank could provide. As Joseph French Johnson, an economist, professor, and journalist of the time, wrote in 1908, "there is only one simple, sure and safe way out of our financial wilderness ... a central bank of issue under government control."[236] Congress formally established a central bank with the passage of the Federal Reserve Act in 1913 and the formal founding of the Federal Reserve System in 1914. Past objections were not forgotten, however, and the new bank would not be a return to 1836; unlike the First and Second National Banks, it would be under the control of the federal government.[237]

While the establishment of a central bank in 1913 was perhaps the most significant step in rebuilding federal power, it was designed to help stabilize the macroeconomy and not to curb corporate power. Just after creating a central bank, Congress passed the Federal Trade Commission Act of 1914, aiming "at preventing growth of private power which might ripen into restraint."[238] Congress passed the Clayton Act in the same year, in a further attempt to curb corporate power; it attempted to make it "difficult to create new horizontal mergers, prevented interlocking directorships, and proscribed price discrimination."[239] However, Prechel highlights the limitations of this act in the federal fight to control corporations, explaining that "although there were widespread political protests opposing industrial consolidation, until 1914 (i.e., Clayton Act), the state's response to corporate consolidation entailed a series of weak and piecemeal policies."[240] Even when the political will could be mustered to legislate more regulation, the regulations were weak or soon turned, by enforcement and interpretation, to their opposite end.

The establishment of the Federal Reserve, the Federal Trade Commission, and the stricter limits of the Clayton Act undoubtedly gave the federal government a stronger stance within the national economy than it had throughout the 19th century, at least after Jackson's 1836 veto. Nevertheless, despite this success and despite the regulatory intent behind these agencies, Geisst, like Perrow, argues that corporate interests continued to dominate the nation: "the Federal Trade Commission was established to examine corporations that were thought to be restraining trade and creating monopolies ... But the term 'unfair competition' was criticized for being

[235] Beckhart, "Outline of Banking History from the First Bank of the United States Through the Panic of 1907," 10.

[236] Johnson, "The Crisis and Panic of 1907," 466.

[237] Ibid.

[238] James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States: 1780–1970* (Charlottesville: The University Press of Virginia, 1970), 82.

[239] Geisst, *Monopolies in America*, 85.

[240] Prechel, *Big Business and the State*, 62.

too vague . . . The FTC met with only limited success until after World War II."[241] The limited success of federal attempts to limit corporate power within the economy may, in fact, have been due not only to the wording of laws but also to the doctrinal framework through which judges approached cases. Specifically, the Supreme Court of the early 20th century still viewed cases through the lens of Classical Legal Thought and its conception of the law as abstract, de-politicized, and removed from any particular social or economic agenda.[242] Proponents of Legal Realism (or the notion that the law should take account of reality—including the unjust distribution of social and economic resources and the way in which the government, via the law, defined certain individuals' property rights over those resources[243]) opposed the Court's antiquated attachment to "objective" laws.[244] Legal Realists argued that such a position effectively perpetuated "those forms of inequality that the market system produced," such as those pursuant to property rights, wealth, and power.[245] In fact, according to the Legal Realists, the method of "neutralizing" the law not only overlooked but also masked "gross disparities of bargaining power" within the market, such as those between railway workers and their employers.[246] As one prominent Legal Realist, the economist Robert Lee Hale, put it, as paraphrased by Horwitz, by passively permitting the market process to allocate resources and rights according to present, imbalanced power relations, the courts were, in fact, authorizing "an organized form of coercion of the weak by the strong."[247] Legal Realism, with its awareness of socioeconomic contexts and the government's role in regulating them, would not fully oust Classical Legal Thought from the federal courts until the 1930s. Until then, conservatives continued to dominate the Supreme Court, a situation that was not surprising since Republicans controlled the White House for 75% of the time from 1860 until 1932.

Even without this change in legal doctrine, limited success at curbing corporate power was nevertheless still possible at the state level in those states where the state chose to regulate the intrastate activities of railroads. Such was the case of California in 1910, when progressive reformers managed to pull the legislature out of the hands of the Southern Pacific Railroad Company. As mentioned in the previous section, the nomination and ultimate election of legislators was highly influenced by the Southern Pacific's self-interested agenda. However, in 1910, reformers succeeded in passing a direct primary bill mandating that candidates be nominated by the populace, and not through conventions corrupted by corporate interests. Olin describes the impact of its passage: "The passage of the direct primary bill, however, prevented the Southern Pacific from dictating the selection of candidates for all offices in the

[241] Geisst, *Monopolies in America*, 86.

[242] Horwitz, *The Transformation of American Law, 1870–1960*, 194.

[243] Ibid., 197.

[244] Ibid., 48, 52.

[245] Horwitz, *The Transformation of American Law, 1780–1860*, 210.

[246] Ibid., 201.

[247] Horwitz, *The Transformation of American Law, 1870–1960*, 195.

1910 election. By abolishing nominating conventions, the bill enabled candidates to appeal directly to the electorate for their nominations."[248] A similar movement away from corporate corruption and toward direct democracy occurred at the national level in 1913, with the passage of the Seventeenth Amendment requiring the direct election of US Senators.

Political reform by states such as California was a necessary but far from sufficient step toward regulating the massive US railroad industry, not to mention the country's corporate sector as a whole. As noted previously, by the late 19th century, the business activities of many corporations reached far beyond the borders of the states in which they were chartered. In doing so, they also reached beyond the regulations stipulated within these states' charters, since the Constitution endowed the federal government with jurisdiction over interstate commerce. As a result, no matter how much reformers undermined the political influence of business interests, state governments remained relatively powerless in the realm of business regulation.

Yet the federal government was no more successful than the states in its efforts to regulate business, since it had the constitutional right but not the actual resources by which to do so. Put simply, without being the originator of a corporation's charter, the federal government could neither stipulate the terms of a corporation's rights nor threaten to revoke those rights in the event of a breach of those terms. Corporations were in this way largely free from regulation at both the state and federal levels for activities outside their charter state. Professor of history Martin J. Sklar explains this absence of government authority well, stating the "... regulation of interstate commerce [fell] into a limbo between state and federal jurisdictions, reachable by neither ... The states, it was said, created the agent, the operating corporation, but could not regulate the agent's market activities beyond the state's borders; the federal government, on the other hand, could not effectively deal with the interstate market activities because it could not touch the agent."[249] By the late 19th and early 20th centuries, reformers were well aware of this "limbo" and sought to address it directly through the establishment of federal chartering.

Federal Chartering as Another Approach to Regulating the Common

By the early 20th century, many reformers advocated altering the laws governing the economic system, particularly the system of chartering corporations. Instead of allowing the states the exclusive power charter corporations, they recommended granting power to the federal government to license or charter firms to engage in interstate commerce. This was not a new idea. At least twice during the Constitutional Convention in 1787, James Madison proposed allowing federal chartering, anticipating that firms could grow to sizes "so extensive that they would pass

[248] Olin, *California's Prodigal Sons*, 13.
[249] Sklar, *The Corporate Reconstruction of American Capitalism*, 196.

beyond the authority of a single state, and would do business in other states;"[250] Madison feared the prospect of uncontrolled corporate power, having already witnessed its effects in Britain by the late 18th century.[251] To prevent businesses from eventually growing beyond the point of accountability to government, he believed that the federal government ought "to grant charters of incorporation in cases where the public good may require them, and the authority of a single State may be incompetent."[252] However, this idea was never formally proposed because it implied a degree of added federal power that was thought to be likely to derail ratification of the Constitution itself. In addition, according to Urofsky, as the Convention granted the federal government greater powers, Madison and others began to advocate for limits to that power and thus dropped the issue of federal chartering of firms.[253] Over a century later, the issue would arise again, as Madison's premonition had become a reality.

Regulation of business through establishing and enforcing rules of conduct proved to be extremely difficult because the statutes, in order to pass, had to be weakly worded. Reformers thus turned to another approach. As early as 1900 Congress began to consider the merits of the federal chartering of firms. A federal charter could impose a specific set of responsibilities on all firms. Between 1901 and 1907 six separate chartering bills were submitted[254] and by 1914, nearly two dozen such measures had been proposed; yet all ultimately failed to get through both houses of Congress.[255] At the same time, leaders of the executive branch also became interested in curbing corporate power through the federal issuance of charters. President Theodore Roosevelt advocated such a measure in his run for Vice-President, and later, as President, spoke extensively on the issue. In a 1902 speech in Rhode Island he declared, "I do not believe that you can get any action by any State ... I do not believe it practicable to get action by all the States that will give us satisfactory control of the trade of big corporations."[256] In pursuit of this ultimate goal, President Roosevelt established the Bureau of Corporations within the Department of Commerce in 1903, intending to utilize "publicity as an aid in bringing about executive control of the trusts."[257] James R. Garfield, son of former President Garfield, initially headed the Bureau of Corporations as he shared Roosevelt's desire to curb corporate corruption.

[250] Brabner-Smith, "Federal Incorporation of Business," 159.

[251] Ibid.

[252] Ibid.

[253] Melvin I. Urofsky, "Proposed Federal Incorporation in the Progressive Era," *The American Journal of Legal History* 26, no. 2 (April 1982): 171.

[254] Theodore H. Davis, Jr., "Corporate Privileges for the Public Benefit: The Progressive Federal Incorporation Movement and the Modern Regulatory State," *Virginia Law Review* 77, no. 3 (April 1991): 623.

[255] Urofsky, "Proposed Federal Incorporation in the Progressive Era," 176.

[256] Ibid., 169.

[257] Arthur M. Johnson, "Theodore Roosevelt and the Bureau of Corporations," *The Mississippi Valley Historical Review* 45, no. 4 (March 1959): 575–576.

After his installation, Garfield investigated industries where corruption was suspected and spoke extensively on the topic. As legal historian Melvin I. Urofksy notes, Garfield believed that "when a railroad or a great industrial corporation has exercised influence over the legislative bodies of the commonwealth, or has controlled the selection of men in public office, that corporation has gone entirely outside of its proper and legitimate sphere of action, and has become an enemy to the public welfare and the common good."[258] In order to defeat these "enemies" of the public welfare, Garfield advocated a federal role in control of corporations: "A single state cannot control the great interstate corporations. The nation is the only sovereignty that can control them. The nation is the only government big enough and strong enough to cope with the modern-day industrial combination."[259] President Roosevelt echoed Garfield's words in 1905: "Experience has shown conclusively that it is useless to try to get any adequate regulation and supervision of these great corporations by State action. Such regulation and supervision can only be effectively exercised by a sovereign whose jurisdiction is coextensive with the field of work of the corporations—that is, by the National Government."[260]

As early as 1904, Roosevelt and Garfield had so popularized the issue that "the legal and popular press carried literally dozens of articles on the subject, with the vast majority of writers urging federal incorporation as the only practicable method of controlling the trusts."[261] President Taft would continue the executive's call for federal incorporation, speaking to Congress on the topic in 1910. In his words, "no other method can be suggested which offers federal protection on the one hand, and close federal supervision on the other of these great organizations that are, in fact, federal because they are as wide as the country and are entirely unlimited in their business by state lines."[262] That same year, Taft endorsed a bill proposed by Attorney General George W. Wickersham advocating federal incorporation. The bill placed strict requirements upon firms; specifically, it "forbade a federal corporation from purchasing, acquiring or holding stock in another company, nor could it engage in banking. Strict standards of financial accounting and publicity were required, with annual reports filed with the Bureau of Corporations. Any extraordinary activities, including issue of new stock, had to be cleared with the Commissioner, and violations could lead to forfeiture of charter."[263] Nevertheless, despite such explicit support by Roosevelt, Garfield, Taft, other politicians, and the press, measures instituting federal incorporation still failed to pass through

[258] James R. Garfield, "Publicity in Affairs of Industrial Combinations," *Annals of the American Academy of Political and Social Science*, vol. 42: Industrial Competition and Combination (June 1912), 143–144.

[259] Ibid., 145.

[260] Davis, "Corporate Privileges for the Public Benefit," 622.

[261] Urofsky, *Proposed Federal Incorportion in the Progressive Era*, 173.

[262] Brabner-Smith, "Federal Incorporation of Business," 163.

[263] Urofsky, *Proposed Federal Incorportion in the Progressive Era*, 180.

Congress, and with the creation of a central bank and the Federal Trade Commission in 1913–1914, the issue was ultimately dropped.[264]

Why did Congress fail to support the federal chartering of corporations? One reason could have been the claim that the measure was unconstitutional; some legislators argued that the power to grant charters belonged exclusively to the states and not the federal government.[265] Yet, as Davis explains, this argument was refuted by many contemporary commentators who pointed out that Congress did, in fact, have such a power, confirmed by the Supreme Court's approval of its chartering of national banks from the mid-19th century onward.[266] Garfield also refuted such a claim, on the grounds that corporations engaging in interstate commerce fell under federal jurisdiction and could be regulated by requiring them to have a license in order to engage in interstate commerce.[267] The terms of the license would effectively change their terms of incorporation.

Businesses, including some of the major trusts and associations, generally appeared to support the measure, appreciating the benefits of achieving uniform rules across their interstate operations.[268] Of course, as Urofsky notes, those "business spokesmen who favored a federal charter law believed that they could secure one which would not unduly inhibit their activities," since their potential influence over those drafting and proposing it was considerable.[269] With constitutional concerns and business blocks discounted, Urofsky thus concludes that the main obstacle to successful passage of a law enabling federal chartering of corporations was the inability of legislators and the special interests influencing them to agree upon the specifics, such as the inclusion of labor organizations. There was agreement that the federal government could issue charters, but the exact terms of the charter were beyond consensus.[270] In the event, this attempt to regulate the US market would also fail.

Driving Business Out of Politics: The Fight for Direct Election of US Senators

The corruption of politics by business was just as prevalent and criticized—if not more so—at the federal level as it was at the state level during the late 19th and early 20th centuries. US Senators were especially accused of corruption, since they were nominated by state legislators who were themselves under the sway of special

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[264] Johnson, "Theodore Roosevelt and the Bureau of Corporations," 589; Davis, "Corporate Privileges for the Public Benefit," 624.

[265] Davis, "Corporate Privileges for the Public Benefit," 625.

[266] Ibid., 626.

[267] Garfield, "Publicity in Affairs of Industrial Combinations," 145.

[268] Urofsky, "Proposed Federal Incorporation in the Progressive Era," 167.

[269] Ibid., 176.

[270] Ibid., 176.

interests. As a result, "reformers dismissed individuals elected by such legislatures as puppets and the Senate as a 'millionaire's club' serving powerful private interest."[271] Muckrakers such as David Graham Phillips joined Progressive reformers in their condemnation of US Senators. In one of the most influential of the muckraking articles entitled "The Treason of the Senate," published in *The Cosmopolitan* in 1906, Phillips referred to some of the state legislators as "unblushing corruptionists," "obsequious servants of corruption," and "traitors to party as well as the people."[272]

In "The Treason of the Senate," Phillips highlighted several such instances committed by Senator Nelson W. Aldrich of Rhode Island.[273] According to Phillips, Senator Aldrich was a pawn of big business and, accordingly, had prevented tariff laws unfavorable to business interests from passing through the Senate on three separate occasions.[274] In addition, Phillips detailed how Aldrich managed to manipulate each tariff bill, as it came to the Senate—in 1890, 1894, and 1897—so that it included "provisions for loot for each and every one of Aldrich's powerful clients" which could thereby "enrich 'the interests' with the earnings and savings of the masses."[275] Phillips specifically charged that among those benefiting from the added "provisions for loot" were the "suppliers of campaign funds and tips on stocks and shares of 'good things,' and of funds to be lost at poker to congressmen too 'honest' and too 'proud' to accept a direct bribe;" in short, Phillips was claiming that Senators such as Aldrich were essentially siphoning off funds to businesses who were sure to return the kindness.[276] Phillips furthermore alleged that Senator Aldrich, along with his "right-hand man" Senator Gorman, a Democrat from Maryland, had established a bipartisan machine dubbed "the political trust" that was funded by "the interests"

[271] National Archives and Records Administration, "Progressive Reform: The Direct Election of Senators," *Treasures of Congress: An Exhibit in the National Archives Rotunda, Washington, DC; January 21, 2000–February 19, 2001*, http://www.archives.gov/exhibits/treasures_of_congress/text/page17_text.html.

[272] David Graham Phillips, "The Treason of the Senate," *Cosmopolitan*, April 1906, 632.

[273] Despite the bad press and his clear connection to big business, Senator Aldrich was able to maintain power within Rhode Island due to the state's antiquated apportionment system; each town, no matter how large or small, was allowed only one senator, such that "twenty towns with a total population of 41,000, about 7% of the state's total, could actually control the upper house, a circumstance which guaranteed the selection of business-oriented Republican United States senators," such as Aldrich. [Quote from John D. Buenker, "The Urban Political Machine and the Seventeenth Amendment," *The Journal of American History* 56, no. 2 (September 1969): 310]. Rhode Island was not the only state with such a system; according to Buenker, both Connecticut and Rhode Island were "notorious examples of the 'rotten boroughs of New England.'" [Quote from John D. Buenker, "The Politics of Resistance: The Rural-Based Yankee Republican Machines of Connecticut and Rhode Island," *The New England Quarterly* 47, no. 2 (June 1974): 215.]

[274] Phillips, "The Treason of the Senate," 634.

[275] Ibid., 634–635.

[276] Ibid., 635.

and that came to dominate the Senate for almost two decades, at the very least with respect to economic issues.[277]

Another instance of corruption stood out to the press and the public in the early 20th century with the struggles to pass a federal income tax. As historian Elizabeth Burt describes, despite the support of most of Congress and President Theodore Roosevelt, the tax was opposed by "corporate and special interests that succeeded through lobbying, influence, and bribery in blocking a total of 33 proposals for an amendment made in Congress between 1895 and 1909."[278] The amendment was finally approved and ratified in 1913, after a series of investigations into the corruption of politics by corporate interests "momentarily weakened" the latter's influence.[279]

As indicated previously, relatively lax federal oversight allowed firms to engage in a host of practices—including buying up other firms, even in the same industry, and eventually amassing enough economic power to gain a back-door entrance into politics. And as legal historian Theodore H. Davis, Jr. recounts, the federal government and its weak regulations had no effect upon firms even by way of the state governments; the latter, in fact, focused on removing any such regulations as they competed for the income generated by granting corporate charters. Ineffective oversight by both the federal and state governments thus permitted a massive consolidation of corporate power whereby "competition among small firms evolved into monopolistic control of entire industries."[280] Between 1898 and 1901, 2,274 firms disappeared in mergers that had a total capitalization of $5.4 billion.[281] The century-long system of state chartering thus enabled economic power to concentrate in the hands of a few large firms which could then be translated into political power through bribery, similar to that seen in the case of the Southern Pacific Railroad Company in California or the trusts that dealt directly with Senators Aldrich and Gorman. Urofsky corroborates this conclusion, stating that corporate law was "dragged . . . down to the lowest common level" by state competition, to the point where the states themselves were "either unwilling or unable to control corporate abuses," such as the application of their power to politics.[282]

Burt explains how the system worked at the state level in California: "In selecting US senators, state legislators were often influenced by pressures from their most powerful constituents—those who controlled local and regional business and industry. In the most egregious cases, wealthy and powerful men were able to buy Senate seats for themselves or their friends. As a result, corruption, inefficiency,

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[277] Ibid., 633.

[278] Elizabeth Burt, *The Progressive Era: Primary Documents on Events from 1890 to 1914* (Westport, CT: Greenwood Press, 2004), 268.

[279] Ibid., 269.

[280] Davis, "Corporate Privileges for the Public Benefit," 620.

[281] Ibid.

[282] Urofsky *Proposed Federal Incorporation in the Progressive Era*, 164.

disorder, and even paralysis existed at the level of both the state legislatures and the U.S. Senate."[283] The corporations were able to influence the political system so that it was just as problematic as the economic system.

Although reformers had limited success in curbing corporate power, they were able to alter one of the means by which corporations had been using their power to manipulate politics to their advantage: the election of US Senators. Proponents of the direct election of US Senators believed that direct election would remove "the selection of United States senators from the state legislatures, where it could be readily manipulated, and place it in the hands of the voters where, presumably, it could not."[284] Starting in 1904, proponents of an amendment allowing for the direct election of US Senators persuaded several state legislatures to adopt what was called the "Oregon model," a state-based precursor to direct election on a national level. Basically, legislators of these states pledged to "honor the outcome of popular referenda on the Senate contests in their state."[285]

During the next few years, several attempts were made to apply this model nationally. Between 1893 and 1902, the House adopted the measure on five different occasions, but each time "the amendment died in the Senate, where few members were willing to abolish the system to which they owed their seats."[286] Despite struggles in Congress, support for the amendment continued to build. During the early 1900s the Populists and the Democrats formally promoted it as part of their campaigns, and by 1912, 29 of 48 states had adopted a system to elect their senators through "either preference or direct primaries," both precursors to direct election.[287] Progressive politicians such as Robert M. La Follette, and economists such as Richard T. Ely and John R. Commons also spoke in favor of the direct election of US Senators.[288] Commons, for instance, declared in an article in 1908 that class conflict in America would disappear only "when the public shall have more means of expressing its will, through direct nomination, direct election . . ."[289] But as business professors Alexander Dyck, David Moss, and Luigi Zingales describe in their working paper, the most effective support for the measure came from muckrakers such as David Graham Phillips, who spread an inflammatory message against special interests in the Senate that, they argue, caused Senators to vote

[283] Burt, *The Progressive Era*, 327.

[284] Buenker, "The Urban Political Machine and the Seventeenth Amendment," 305.

[285] Sara Brandes Crook and John R. Hibbing, "A Not-so-distant Mirror: The 17th Amendment and Congressional Change," *The American Political Science* Review 91, no. 4 (December 1997): 845.

[286] Burt, *The Progressive Era*, 328.

[287] Ibid.

[288] Sanford D. Gordon, "Attitudes towards Trusts prior to the Sherman Act," *Southern Economic Journal* 30, no. 2 (October 1963): 167; Editorial Board, "Name La Follette For the Presidency: Progressive Republicans Start an Active Boom at Their First National Conference for Presidential Primary," *The New York Times*, October 17, 1911.

[289] John R. Commons, "Is Class Conflict in America Growing and Is It Inevitable?" *The American Journal of Sociology* 13, no. 6 (May 1908): 764.

differently.[290] According to Dyck, Moss, and Zingales, Phillips was particularly influential through his series of articles on "The Treason of the Senate"; in one such article Phillips accuses several Senators of "bribery and party prejudice," of causing "more than half of the wealth created by the American people [to belong] to less than one per cent," and of "promoting thievish legislation, preventing decent legislation, devising ways and means of making rottenest dishonesty look like honesty and patriotism."[291]

Burt agrees that Phillips' strong language was influential in inciting action toward passage of an amendment for direct election of US Senators.[292] However, she argues that the real catalyst for change was a set of investigations into the corrupt activities of legislators launched by the press starting in 1910, when Illinois Representative Charles A. White was accused of, and subsequently admitted to, receiving bribes to vote for US Senate candidates, in his case William Lorimer in 1909.[293] Burt explains that between 1910 and 1912, these investigations continued and "other lawmakers came forward with stories of bribery, and the election of at least one other senator, Isaac Stephenson of Wisconsin, was investigated. The continuous press coverage of the charges and investigations . . . eventually led to his [Lorimer's] expulsion from the Senate in July 1912." With the press and public opinion thus inflamed, the Senate finally passed an amendment instituting the direct election of US Senators in 1911 and, after approval by the House, President Taft, and the states, the Seventeenth Amendment became law in May 1913.[294] Thus, the federal government may not have been able to control the growth of corporate powers through chartering, but it would now at least be somewhat more independent from the potential political influence of these powers.

Corporate Oligarchy Prevails

Despite the establishment of the Federal Reserve Bank and the Federal Trade Commission and the ousting of corporate interests from the California legislature and the US Senate, by the 1920s the general trend in the United States was still an increasing concentration of corporate power, particularly within major industries such as the railroads, steel, sugar, and tobacco. Geisst explains that despite heightened federal involvement through newly established economic agencies, businesses were still able to manipulate the government and the public: "Business, employing new technologies eagerly sought by the public, began to circumvent the antitrust

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[290] Alexander Dyck, David A. Moss, and Luigi Zingales, *Media Versus Special Interest*, Working Paper (George J. Stigler Center for the Study of the Economy and the State, The University of Chicago, September 2008), research.chicagobooth.edu/economy/research/articles/224.pdf.

[291] Phillips, "The Treason of the Senate," 628, 632, 637.

[292] Burt, *The Progressive Era*, 329.

[293] Ibid.

[294] Ibid., 330.

laws as flagrantly as at any time in the past" in the 1920s.[295] Given the leeway that politicians and judges still had in interpreting the vague wording of the antitrust laws, and given the influence that corporate actors could still wield over these authorities, such circumvention comes as no surprise to scholars such as Prechel; according to him, big business was at this time just as "directly involved in defining federal laws regulating their own behavior" as it was with "regional state laws of incorporation in the late 1800s."[296] As a result, corporate consolidations with their inevitable concentrations of wealth and power continued through the early 20th century, with the number of companies being acquired by others increasing by a multiple of almost 20 between 1918 and 1929.[297] Geisst further notes that great economic inequalities between the average worker and corporate giants persisted though they remained relatively unaddressed: "amidst what appeared to be prosperity, the wages of the average worker were actually dropping. The rich got richer while the working class scraped to make ends meet."[298]

1900–1937: Alternative Models of Capitalism: The Roles of Legislatures and Courts in Governing US Capitalism

Drawing on the various works of US legal scholars and business historians such as Duncan Kennedy, Stephen Skowronek, Laurence H. Tribe, Morton J. Horwitz, Martin J. Sklar, and Justice Robert H. Jackson, this section offers a condensed narrative of the competition between the legislatures and courts to define the basic principles through which US capitalism would govern the US economy. The legislatures expected to address these new inequalities through remedial legislation while the courts tended to be guided by common law, which regarded the existing distribution of power as legitimate except insofar as a change could be presumed to benefit society as a whole rather than one individual or group versus another. The central issue was whether the existing distribution of wealth and power should be considered the result of natural forces, and therefore legitimate and not to be interfered with by the legislature except in rare instances, or whether the new conditions, with much larger firms, more concentrated economic power, and unprecedented opportunities for private coercion should be considered legitimate grounds for governmental intervention, and legislative intervention in particular.

At the founding of the country in 1787, as previously noted, the US economy was characterized by atomistic competition where most economic actors had little power to influence prices. In this context the Framers of the Constitution established a weak federal government, granting it broad powers in principle such as the right

[295] Geisst, *Monopolies in America*, 92.

[296] Prechel, *Big Business and the State*, 67.

[297] Geisst, *Monopolies in America*, 94.

[298] Ibid., 93.

to regulate interstate commerce, but little by way of real powers with which to influence the economy. The federal government had no mandated right to charter firms and thereby set conditions upon them in return for an explicit license to compete in the US market. Its two successive attempts to circumvent this limitation by chartering a national bank eventually failed; believed to be unconstitutional concentrations of power, both charters were allowed to lapse. In addition to an absence of chartering powers, until the 1930s, the federal government had little by way of administrative capacities to oversee or regulate the increasingly large and diversified market. Thus, as a general rule, the state was not to interfere with individual rights as delineated by the Constitution or by common law (e.g., property and free contract rights).

The above constitutional reasoning against federal regulation of the economy was further buttressed by contemporary responses to the growing US economy. Specifically, an ideology of laissez-faire (retrospectively dubbed Classical Legal Thought by Duncan Kennedy) was adopted by businessmen, politicians, and judges in order to ostensibly promote the economic freedom of individuals as an implicit strategy for industrial initiative and innovation, which were believed to be the key drivers of economic growth. The Civil War played a role in implementing this conservative economic ideology; a Republican administration led by Abraham Lincoln won the war, and for decades its political successors would not let the nation forget that its Democratic opponents had backed secession. This helped make the Republicans the dominant party and laissez-faire the dominant economic ideology over the years 1860–1932. During that period, Republican presidents occupied the White House 75% of the time, and were thus enabled to have the upper hand in the selection of justices for the Supreme Court. Unsurprisingly, from the 1870s onward the Supreme Court stood out for its overwhelming adherence to Classical Legal Thought and its laissez-faire policy implications, actively separating the state from the economy to prevent political forces from supposedly distorting market forces. Such reasoning meant that in the United States, those decisions that in other countries would likely be settled by legislatures, based on political considerations, were settled by courts as legal questions.[299] In short, writing a weak federal state into the Constitution, incorporating it into law via the ideology of Classical Legal Thought, and implementing it via a Republican majority, together contributed to a rise in the relative power of the judiciary and of the Supreme Court in particular, unparalleled and even opposite to the trends of other western nations of the time. In these ways, the Court ultimately came to obstruct liberal economic reform in the United States, such as that called for by politicians and the public alike by the 1930s. US capitalism could not change until the legal bulwarks underpinning the Court—Classical Legal Thought and judicial supremacy—were effectively undermined.

Was it possible for the United States to experience the great economic growth of the 19th century without following this politico-legal path to weak government? Was it possible for the United States to achieve spectacularly rising incomes and economic power without disempowering the federal government and empowering giant

[299]See Jackson, *The Struggle for Judicial Supremacy: A Study of the Crisis in American Politics*.

firms to create a largely unregulated market that effectively subverted democracy? Were there alternatives to a capitalist system dominated by a corporate oligarchy of giant, private firms, alternatives that might still have permitted the capture of most of the economies of scale and intra-organizational coordination? In short, were there alternative forms of capitalism that the United States might have either adopted at its birth as a nation or into which it might have at least transformed later on? Perrow points out two potential such alternatives, Horwitz points out a third within the legal system, and I would add a fourth that is implicit in Perrow's analysis.

First, there was the model of the state-owned enterprise developed briefly by some of the states and that would come to operate throughout much of Europe after World War II and continue to operate most such railroads today. Given the potential size and economic power that the railroads would represent at this stage of US development, a state-owned right of way, perhaps with track included, would grant the federal government a larger role in the economy than when it built the interstate highway system a century later because by then the economy was so much larger. Several US states started down this path, including Georgia and Massachusetts, but they abandoned it in the wake of the loss of confidence in public infrastructure development following the bankruptcies of many state-sponsored canals in the 1840s. It is hard to argue that states could not have successfully operated railroads in the United States when so many other "states" or countries were able to run railroads, albeit mostly much later and through other political and legal institutions or variations of capitalism. Furthermore, it is not obvious that such state-run railroads would have wasted more money or done more economic damage than the chaos of the US railroad industry in the 1870s–1890s, when recession, duplicative capacity, and rate wars led to the bankruptcy of more than half of US railroad mileage.

On the other hand, given the weak federal state built into the Constitution, there might have been problems establishing the accountability of any such state-owned firms to any interests other than their own, as there had been with the Second National Bank in the early 19th century. One cannot claim that the United States could simply have followed the British or French models to similar effect, because both had much stronger states. Still, this was an alternative that might have been mastered; civil servants could certainly learn to run trains in two directions and might well have been more responsive to public interests than the "Robber Barons" in choosing where to locate the rail lines that would shape the country.

Support for this view comes from Skowronek, who argues that the United States took an aberrant and, in retrospect, unwise path in actively avoiding government oversight of the railroads and other emerging industries. He explains: "With the consolidation of their national railway networks in the second half of the nineteenth century, the Western states shared their first common experience of the new demands for business regulation raised by an industrial economy."[300] These

[300] Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877–1920* (Cambridge: Cambridge University Press, 1982), 121.

demands were, on the whole, met by some form of "national administrative supervision," with the government of each state taking control of the railroad and those other industries that were undergoing rapid growth on a national scale.[301] But the United States proved an exception, leaving the control of such corporations almost entirely to the private sector. Government intervention on the scale adopted by other western states "ran counter to the main currents of American state development;"[302] (e.g., the suspicion of a strong central state, the resulting division of state powers in the Constitution, and the prioritization of individual property and contract rights via common law and the prevailing ideology of Classical Legal Thought). As Skowronek notes, these "entrenched governing formulas stymied bold departures in institutional development," departures that other countries embraced as necessary to respond to the new, industrial economy of the 19th century. US firms thus continued to consolidate their assets and exercise considerable market power, as they were left effectively unchecked by any branch of the federal government.[303] The glaring discrepancy between business regulation in the United States and that abroad, noted by scholars such as Skowronek today, were even evident at the time. In 1898, the ICC (the main federal regulatory agency) complained that "only the United States insisted on enforced competition" and thereby precluded its own agencies from effectively supervising monopolistic industries such as the railroads.[304] Yet, as shown throughout this chapter, the United States continued on its exceptional path, eschewing effective regulations by the federal government until the 1930s, with FDR's aggressive implementation of liberal New Deal policies.

As a second option, there might have been some regional railroads created with franchises like that granted much later to the Tennessee Valley Authority. Several such regional railroads, each with a restricted geographic franchise yet partially competitive with one another, were created in a model that resembled the British, with their regional, private railroads prior to nationalization in the 20th century. Perrow touches upon this regionalization option in his discussion of flexible networked firms that were successfully implemented by Philadelphia textile mills through the 1880s.[305] Rescue of the Second National Bank would have made any such initiatives easier by providing the federal government with both the financial and administrative power to support and even shape regional development. Surely, the creation of regional railroads and associated regional economies was an option that might have had promise during the formative decades of US industrialization, even if not indefinitely, and might also have helped direct other industries toward more regional development with small- to medium-scale firms.

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[301] Ibid.

[302] Ibid., 122.

[303] Ibid.

[304] Ibid., 159.

[305] Perrow *Organizing America*, 81–83.

Horwitz reveals that a third option arose within the legal system in his account of Progressive reformers' efforts to reform the Free Market or Classical Legal Thought in order to bring the law closer to market realities. In following Classical Legal Thought, the courts had largely ignored obvious economic inequalities and vitiated the efforts of legislators to correct them. The Supreme Court, in particular, strictly upheld the classical notions that markets should be self-governing and that economic efficiency, as indicated by contracts, should take priority over policies that might try to redistribute incomes or wealth in order to correct a wrong, as in the *Lochner* decision of 1905. *Lochner*, in fact, acted as a spur to the Progressives and so-called Legal Realists who called attention to the fact that power relationships were rarely equal and that the state might have good reason to intervene as, for example, in trying to limit the hours worked by the *Lochner* bakers, by women and children, or by steel mill workers. Yet Classical Legal Thought dominated a closely divided Supreme Court until a single judge changed sides in 1937.[306]

The alternative that is implicit in Horwitz's analysis of US legal thought in the latter 19th century is that the courts could have reshaped US development had they moved sooner to a doctrine that took more realistic account of inequalities of power, including those inequalities generated by capitalism itself. For instance, if the Supreme Court had sustained New York in its regulation of the hours of bakers, it could have opened the way for recognizing the role of the states in the governance of capitalism, not by interfering in firm goals and strategies but rather by setting rules governing firm behavior. States would act like the political authority of an organized sport, setting, monitoring, and modernizing the rules as conditions changed. Obvious as this point may seem in hindsight, seeing it requires redefining the 19th-century view of the role of the firm in a private enterprise economy. Did the notion of private enterprise held by courts at that time denote ownership and rights to income, as for a professional sports team, or did it prioritize private agreements between management and labor relative to public policy concerns even if the bargaining table was tilted heavily to favor the former? Could the courts have reshaped US capitalism by trying to limit the powers of capital relative to labor as well as creating a stronger role for rules and referees? (Given the corporate influence on the executive branch, including its choices of judges, this option may have been more theoretical than real.)

The Classical Legal Thought governing court opinions in the late 19th century saw the firm as a private enterprise existing outside of any notion of a capitalist system of governance. It cast away earlier conceptions of the firm as an entity granted legal existence by a state; instead, the firm was an autonomous, natural entity inherently possessing the rights to mobilize savings and operate through a self-selected hierarchy while also protected by limited liability. Court opinions at the time effectively protected such firm autonomy by undermining the notion of firm accountability to any authority, even when it would mean allowing private contracts to take precedence over

[306] Horwitz, *The Transformation of American Law, 1870–1960*, 3, 7, 219, 230.

societal concerns.[307] Corporations and their managers were in this way legally authorized and even encouraged to actively ignore the interests of the government, the public, and eventually the shareholders.[308]

Actually, not one but two alternatives stand out in Horwitz's account, as he has pointed out. First, accountability might be achieved through a top-down process of chartering and administrative monitoring, such as by a judiciary more attuned to real inequities in power, as just suggested. Second, it might be achieved bottom-up by making management accountable to its board of directors and the latter to the shareholders. But the problem with this latter option, then as now, was how to ask a disparate bunch of shareholders, knowing little about a firm and having no necessary long-term commitments to it, to serve as the ultimate source of accountability for its governance. The bottom-up shareholder model of governance was and remains fine for private firms with a small number of shareholders who have long-term commitments to their firms because they do not have a ready exit thanks to an illiquid market for their shares. In contrast, public stock markets provide this ready exit and consequently undermine shareholders' long-term interest in the firm; so while they empower large public firms, they decrease shareholder interest below that of firm employees, undermining the bottom-up shareholder model of governance. One of the generic asymmetries of capitalism thus arises: capital is more mobile and can therefore be less committed than labor. Is there some set of internal governance processes for firms that will pay due respect to the fact that firms are permitted by society to have rights and powers that individuals do not have, starting with the right to limited liability for those very investors? These are questions still very much alive today.

Classical Legal Thought played a pivotal role in obscuring this basic problem of governance and thus distorting the developing system of US capitalism to prioritize private contracts over public needs, no matter how legitimate the latter might be. It was as though the lawyers and legal scholars of the 19th century persuaded American leaders, political as well as economic, that capitalism—a word hardly known at the time—was a system of natural laws, like those of physics or chemistry or biology, and not a system of political constructs devised by society for the governance of economic relationships. For want of a clear recognition of capitalism as a system of economic governance, public discourse was impoverished and a distorted ideological view of capitalism as natural law came to prevail. In this way, Classical Legal Thought was and remains a forerunner of the ideas of Milton Friedman in the post-World War II era, as explained in Chap. 2. Indeed, its doctrines have returned through his works to play a very strong role in conservative economic and legal thought in the United States since the 1960s.

However, none of the alternatives just noted had any significant impact in the 19th century, and only slightly more during the Progressive era. It was not until the 1930s, as Perrow and Geisst both note, that the fundamental power relationships

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[307] Ibid., 194.

[308] Ibid., 77, 85, 94, 98, 101–102.

between corporate interests and the public interest finally began to change. As with the case of creating the Federal Reserve System, it took an economic crisis—the Great Depression—to open the way for effective reform.

The Gilded Age of the Late 19th and Early 20th Centuries: The Rise of Classical Legal Thought and Judicial Supremacy

The rest of this section chronologically traces the path by which this conservative, common-law ideology, and its corresponding primacy of the judiciary developed during the Gilded Age (late 19th and early 20th centuries), peaked during the *Lochner* era (1897–1937), faced challenges both ideological and political throughout this time, and finally fell in 1937.

The dominance of Classical Legal Thought during the Gilded Age is ably accounted for in the work of Duncan Kennedy, a Harvard law professor who retrospectively classified this common-law ideology. As innovative industrial technologies and corporate structures revolutionized the US market, judges increasingly relied upon common law to rule on issues absent from the United States' previously agrarian society, unforeseen by the Framers and early lawmakers, and therefore unable to be settled by existing statutes. As inherited from England and as employed by American judges, common law placed the protection of property rights and contract rights above all else.[309] Kennedy draws out the economic implications of this placement, stating that according to common law, "the cardinal principle, the legal foundation of capitalism, was that the state must respect the will of private parties concerning property and contracts,"[310] and, as a result, "any other rules of contract law than those dictated by the general principle of freedom must inhibit exchange

[309] "Common law" refers to judge-made law, or law defined by case decisions rather than by legislative statutes. Historically, it derives from medieval England, when courts were the primary institutions by which the law of the country was established. English common law and its associated institutions were imported to colonial America and, after the American Revolution, were actively adopted by many states through the passage of "reception statutes." Aspects of England's "unwritten law" such as property rights and contract rights had, by the late 18th century, come to be understood as part of English common law and were thus also inherited by the early Americans. As this chapter shows, these two principles of common law (individual property rights and contract rights) came to prevail during the 19th century as the Framers and then the courts prioritized individual freedom over state power; they served, in a sense, as a means by which to avoid the tyranny of the English monarchy and Parliament, against which the early colonists had rebelled. As the nascent nation expanded and industrialized, disputes arose for which no statute existed; in such cases, judges referred to and remodeled common law principles for their resolution. This chapter uses "common law" to demonstrate, first, the prevalence of property rights and contract rights within Classical Legal Thought and, second, the rise in judicial authority during the 19th century. [See: *Oxford Reference Online*, s.v. "Common Law" (by John V. Orth), http://www.oxfordreference.com (accessed July 9, 2008).]

[310] Kennedy, "The Role of Law in Economic Thought," 956.

. . . it is but another instance of theft."[311] And since common law was, by definition, based not on statutes but on judicial rulings, judges could interpret and articulate it such that it applied to any case brought before them. In this way, common law could preside over most if not all issues arising from the developing US market and thereby shape US capitalism. As Kennedy puts it, common law and its eventual cohesion into the ideology of Classical Legal Thought came to supply the US economy with "laws of economic life, analogous to the physical laws of nature; the natural operation of those laws brought about just outcomes."[312]

Intertwined with the rise of Classical Legal Thought was the corresponding emergence of judicial primacy, i.e., the dominance of the judiciary over all other government branches and agencies. Historian Stephen Skowronek effectively links these two advancements within the context of the history of the corporate charter and, in doing so, echoes Kennedy's association of US law and US capitalism: "By the late 1830s, an alternative means of fostering economic development had come to the fore—the widespread distribution of special corporate charters. These charters were designed to promote and channel private economic ventures, yet they left to the courts a fairly loose reign over the state's police powers. By interpreting the charters' clauses for the protection of the public interest, the judiciary became the chief source of economic surveillance in the 19th century. Over time, courts molded the prerogatives of government into predictable but flexible patterns of policy toward capital accumulation. This system of control was well established by 1850, when the race for railroad access was becoming the centerpiece of national economic development. The courts had become the American surrogate for a more fully developed administrative apparatus."[313] According to Skowronek, judges essentially became legislators, creating policy by way of upholding only those pieces of legislation in accord with common law and the Constitution, as they interpreted it. By the late 19th century, the courts—the Supreme Court in particular—dominated the US government and propagated what Skowronek dubs the Classical Legal Thought principle of "constitutional laissez-faire," with which "the Court sought to sharpen the boundaries between the public and private spheres, to provide clear and predictable standards for gauging the scope of acceptable state action, and to affirm with the certainty of fundamental law the prerogatives of property owners in the marketplace."[314]

The Gilded Age of the late 19th and early 20th centuries thus marked the simultaneous rise of Classical Legal Thought and judicial supremacy, embodied most evidently in the power of the Supreme Court to prioritize the common law rights (property and contract) of individuals over state intervention within the economy. This power prevailed particularly during the *Lochner* era of 1897–1937.

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[311] Ibid., 957.

[312] Ibid., 958.

[313] Skowronek, *Building a New American State*, 27–28.

[314] Ibid., 41.

The* Lochner *Era of 1897–1937: The Height of Classical Legal Thought and Judicial Supremacy

In his review of the Court during the so-called *Lochner* era of 1897–1937, Harvard law professor Laurence H. Tribe highlights the overwhelming power of US law and legal actors, especially the Court, over the distribution of power within US economy, thus corroborating Kennedy's and Skowronek's respective arguments, detailed above.[315] Tribe notes that the Court's ideological adherence to the common-law freedoms of individuals (e.g., those of property and contracts) during the *Lochner* era narrowed the legitimate scope of state involvement in socioeconomic issues. He argues that Court decisions "were predominantly driven by the justices' desire to maintain 'a normative balance between individual autonomy and state micromanagement.'"[316] This balance was disrupted, according to the Court, when "statutes interfered with private economic transactions" in a way that violated common-law concepts.[317] Over the 30 or so years of the *Lochner* era (1905–1937, more or less), the Court employed this reasoning to repeal a substantial number of state and federal statutes (see Table 13.2). The Court thus, on the whole, upheld the existing distribution of economic power by protecting individuals' property and contract obligations from state intervention or what Court opinions often referred to as "coercion."

Oftentimes, the Court prevented state intervention in the economy even when the terms of the contracts in question appeared substantively unjust, as in the cases

Table 13.2 Number of (Federal) laws overturned by the Supreme Court, by decade

Decade	Laws overturned	Decade	Laws overturned
1790–1800	0	1860–1870	4
1800–1810	1	1870–1880	9
1810–1820	0	1880–1890	5
1820–1830	0	1890–1900	5
1830–1840	0	1900–1910	9
1840–1850	0	1910–1920	7
1850–1860	1	1920–1930	19

Source: Justice Robert H. Jackson *The Struggle for Judicial Supremacy: A Study of a Crisis in American Politics* (New York: Alfred A. Knopf, 1941), 40

[315]The term "*Lochner* era" refers to the Court mentality as epitomized in the 1905 *Lochner* case, where the Court held that the state of New York could not set maximum limits to workers' hours, since such regulation would undermine workers' common law right to form contracts free from state interference.

[316]Laurence H. Tribe, *American Constitutional Law*, 3rd ed (New York: The Foundation Press, 2000), 1345.

[317]Ibid., 1346.

of *Lochner v. New York*[318] and *Coppage v. Kansas*.[319] As noted previously in this chapter, in the first case of *Lochner* the Court struck down a New York statute limiting the hours an employer could require his contracted employees to work. In the second case of *Coppage*, the Court similarly struck down a Kansas statute prohibiting employers from writing "no joining unions" clauses into their contracts with employees. In both cases, the actual socioeconomic circumstances were unjust from the perspective of labor; in *Lochner* bakers were left liable to being forced to work over 60 h a week at the risk of losing their jobs, and in *Coppage* railway workers (switchmen) were left liable to being forced to renounce union membership at the risk of losing their jobs. The majority opinion in both cases actively remained neutral to such substantive arguments of injustice, adhering first to Classical Legal Thought's dissociation of law from socioeconomic issues and second to the ideology's common-law prioritization of the individual's right to form private contracts free from state intervention. As Justice Mahlon Pitney wrote in the majority opinion of *Coppage*, "it is from the nature of things impossible to uphold freedom of contract and the right of private property without at the same time recognizing as legitimate those inequalities of fortune that are the necessary result of the exercise of those rights."[320] Pitney's words illustrate well the common-law underpinnings of Classical Legal Thought and the laissez-faire outcomes of their interpretation by the Court.

In his analysis of these cases and others during the *Lochner* era, Tribe elaborates on the relation between the theory followed by the Court and the actual, arguably unjust results: "In broad outline, the underlying philosophy held that the only legitimate goal of government in general, and of the police power in particular, was to protect individual rights and otherwise enhance the *total* public good . . . As a corollary, it followed that any statute which was imposed upon individuals or corporations in order to redistribute resources and thus benefit some persons at the expense of others (for that is how redistribution was then conceived) would extend beyond the implicit boundaries of legislative authority. Such a law would thus violate natural rights of property and contract, rights lying at the very core of the private domain," and, as it were, rights central to the common-law perspective of the judiciary at the time.[321] In this way, Tribe highlights how the Court, during the *Lochner* era in particular, exercised an increasing amount of power over the US economy. And as he, Kennedy, and Skowronek all show, the common-law ideology of Classical Legal Thought were the Court's key tools for the acquisition of additional power as the Justices shaped US capitalism. Increasingly, the courts replaced the legislatures in setting and effectively loosening the rules for participation in the ever-expanding national market.

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[318] 198 U.S. 45 (1905).

[319] 236 US 1 (1915).

[320] 236 U.S. 1, 17 (1915).

[321] Tribe, *American Constitutional Law*, 1348.

Challenges to Classical Legal Thought and Judicial Supremacy in the Early 20th Century: Legal Realism and Calls for More Democratic Government

Despite its dominance during the *Lochner* era, the Court was certainly not free from challenges, both ideological and political in nature. Specifically, the more progressive ideology of Legal Realism questioned the assumptions and actual relevance of Classical Legal Thought, while proponents of a democratic division of federal powers denounced the Court's apparently unconstitutional exercise of judicial supremacy.

According to Kennedy, Classical Legal Thought as a "body of ideas was developing in America between 1850 and 1880, and achieved almost universal acceptance between 1890 and 1914 ... by the 1930's ... it was rapidly losing ground to the diverse forces of sociological jurisprudence, legal realism, and the diffuse legal pragmatism of the New Deal."[322] Horwitz underlines the role of Classical Legal Thought by reminding his readers that this ideology, more than the influence of big business, animated the decisions of the Court, though obviously there was considerable overlap.[323] Kennedy then traces the growing opposition to the conservative, laissez-faire leaning of the law, particularly among Legal Realists, who, he states, believed that "the market was not natural, but rather a social construct."[324] He further notes that "the Great Depression encouraged still further elaboration of the view that, far from being neutral and natural, markets were social constructs that could be judged only by their social consequences ... the premises that lay behind the organization of the market were themselves entirely debatable social choices that could not be justified in scientific terms."[325]

Supreme Court Justice Oliver Wendell Holmes, Jr. (Justice from 1902 to 1932) and Robert Lee Hale, an economist and legal scholar of the Realist orientation (alive from 1884 to 1969), objected to the extent to which the law was out of touch with socioeconomic realities. In particular, Holmes and Hale objected to the artificial dissociation of law from economic concepts such as property. They and many other Legal Realists reasoned that property rights were first and foremost legal rights. Holmes argued that "there was no essence called property that existed prior to law,"[326] and Hale similarly argued that "the market was the actual creator of property and entitlements rather than just being a neutral institution that reflected pre-existing Lockean property."[327] The arguments of Legal Realists gained considerable momentum into the 1930s, as the Great Depression took hold of the nation; however, this ideological challenge to Classical Legal Thought was not

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[322] Kennedy, "The Role of Law in Economic Thought," 952.
[323] Horwitz, *The Transformation of American Law, 1870–1960*, 7.
[324] Ibid., 195.
[325] Ibid.
[326] Ibid., 203.
[327] Ibid., 197.

enough to displace the latter from its prominent position in US law, protected by the conservative majority of the Supreme Court.

A second mode of attack, aimed at the judicial supremacy of the Court, would eventually prove more successful. By the 1930s, the judiciary, the Supreme Court especially, had the final say on the scope of state regulation of the economy, trumping Congress, the President, and the states. Put simply, as long as Classical Legal Thought remained the lens through which US law was interpreted, the Court could declare regulatory statutes and agencies unconstitutional and do so "legitimately;" in other words, its judicial supremacy was both *de facto* and *de jure* in nature. To elaborate: The common-law principles inherent in Classical Legal Thought effectively precluded state intervention in the economy and, using such reasoning, the Court could legally limit the reach of the legislature, the executive, and associated administrative agencies. The reach of the judiciary, however, was not similarly limited for judges, who were seen as neutral vehicles for interpretation as well as enforcement of constitutional and common law. As Kennedy explains, the premises of Classical Legal Thought "placed judges, lawyers, and legal thinkers in the center of the web of government while shielding them from the charge of having usurped the Constitution."[328] Thus, as Classical Legal Thought was increasingly questioned by politicians, the public, and proponents of Legal Realism (noted above), so was the legitimacy of judicial supremacy as exercised by the Supreme Court.

By the 1930s, the theoretical neutrality of Classical Legal Thought and its judicial advocates on the Court became more problematic as Court decisions citing common law resulted in flagrantly undemocratic and unacceptable outcomes. Horwitz, in his review of the rising "criticism of the insensitivity and incompetence of common law judges," cites rising opposition to the Court and Classical Legal Thought as early as 1910, linking it to worker injury and compensation cases where the Court refused to allow the state to intervene.[329] Opposition continued to increase into the 1920s, as the Court continued to hold onto its common-law reasoning despite the publicly objectionable outcomes to which it often led. Sklar notes perhaps the most flagrant of such cases in 1920, *United States v. United States Steel Corporation*, in which the government maintained that the US Steel Corporation's monopolistic market position violated the Sherman Act and, moreover, was contrary to the public interest. Despite considerable public opposition, the Court ruled in favor of the corporation, noting "a merger controlling all or a substantial proportion of an industry could not be construed, on that account, as in violation of the Sherman Act."[330] In each of these cases, the ruling of the Court was, quite simply, supreme and, as Kennedy argues, the Court then maintained this judicial supremacy by exercising a certain "right-wing interventionism of the period 1890–1937 (the rights of property and contract)."[331]

[328] Kennedy, "Toward an Historical Understanding of Legal Consciousness," 9.

[329] Horwitz, *The Transformation of American Law, 1870–1960*, 221.

[330] Sklar, *The Corporate Reconstruction of American Capitalism*, 150.

[331] Kennedy, "Toward an Historical Understanding of Legal Consciousness," 6.

This period of judicial supremacy in the face of undemocratic realities was noted at the time by Robert H. Jackson, then Solicitor General for President Franklin Roosevelt and subsequently a Supreme Court Justice himself. According to Jackson's data, listed in Table 13.2, 58 federal laws were overturned by the Court between 1860 and 1930—twenty-nine times the number overturned by it in all prior years since the nation's founding (1790–1860).[332] And between only 1932 and 1936, of the 11 laws enacted by Congress that it reviewed, the Court overturned seven. Jackson deplored this increasing exercise of judicial power as excessive, illegitimate, and detrimental to US democracy; after briefly noting that the actual outcomes of such rulings could be undemocratic (such as in cases dealing with economic laws), Jackson pointed out that the process itself was undemocratic, as justices were not elected and faced few checks on their power. In his words: "The Court, moreover, is almost never a really contemporary institution. The operation of life tenure in the judicial department, as against elections at short intervals of the Congress, usually keeps the average viewpoint of the two institutions a generation apart. The judiciary is thus ... the check of conservative legal philosophy upon a dynamic people ... This conservative institution is under every pressure and temptation to throw its weight against novel programs and untried policies which win popular elections. Its plain duty to enforce explicit constitutional provisions even in opposition to the majority is easily rationalized into enforcing its own views of good policy. To the extent that it does so, it defeats government by representative democracy."[333] Thus, judicial authority came to be questioned as much as, and alongside, the allegedly neutral principles of common-law buttressing Classical Legal Thought. Taken together, Classical Legal Thought and judicial supremacy provided a way to ensure that markets were allowed to enforce their own discipline, as if they were as neutral as the laws of physics. The status quo distribution of economic power and the political power that had facilitated it were quite clearly undemocratic in the context of the emerging economic crisis of the Depression. Together they drastically curtailed the potential role of the government in coping with the crisis.

FDR Challenges the Supreme Court in 1937: The Fall of Classical Legal Thought and Judicial Supremacy

With the support of a Democratic majority in both houses of Congress, Roosevelt managed to push through an unprecedented amount of legislation for economic recovery and social reform, starting with a burst during his first hundred days in office. But while Congress and the general public rallied behind the president's call to create a more democratic society through government action, the Supreme

[332] Jackson, *The Struggle for Judicial Supremacy*, 40.
[333] Ibid., 315–316.

Court, unsurprisingly, did not; in fact, in the course of 16 months from 1935 to 1936, the Court repealed every New Deal provision brought before it. Composed of four conservatives (commonly referred to as the "Four Horsemen"), two moderate conservatives, and three moderate liberals, the Court was, on the whole, intellectually rooted in the tradition of Classical Legal Thought, limiting state intervention in economic and social issues in order to protect the property and contract rights of individuals and firms (by then legally understood as "persons" or individuals themselves). Given that Roosevelt's liberal policies challenged these legal beliefs and the powerful business interests who also supported them, the Court was ideologically predisposed to oppose his initiatives.

The turning point in the contest between the adherents of Classical Legal Thought and its powerful judicial proponents, and their opponents, came in the middle of the 1930s, brought about by President Franklin D. Roosevelt's refusal to let the Court stymie his ambitious, left-leaning New Deal agenda. Despite Democratic majorities in both houses of Congress in 1932, and with Democratic majorities in most state legislatures as well, Roosevelt did not initially feel strong enough to confront the Court. However, after a landslide victory in 1936 gave the Democrats a 2–1 margin in the Senate and 3–1 in the House, Roosevelt was ready to act. And there was unusual cause. Of 11 New Deal reforms passed between 1933 and the end of 1936, the Supreme Court had overturned seven. Of four major reform bills passed by state legislatures during this same period, the Court had overturned two.[334] Clearly, the Court was asserting judicial supremacy.

Roosevelt did not challenge the actions of the Court as a fundamental obstruction to democratic processes, where an unelected 5–4 majority was overturning precedent shattering majorities in both Houses. Instead, he sent a Judiciary Reorganization Bill to Congress in February 1937. The bill, also known as the Court-Packing Bill, would grant the president the authority to appoint an additional justice for every sitting justice over the age of 70 ½, though a total of no more than 15 justices could make up the Court at any one time. Since the four most conservative justices were all over the age of 70, the bill would enable Roosevelt to appoint justices that would politically reorient the Court in his favor and thereby remove the obstacle it posed to the legalization of his New Deal policies. It was a choice that Jackson believed to be an important opportunity missed, an opportunity to educate the public by challenging what could have been termed a miscarriage of democracy. In making his argument on this miscarriage of justice, Jackson recalled the dissenting opinion of Justice Holmes in the *Lochner* case in which Holmes had stated his view of a very basic point of constitutional law: ". . . a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen to the State or of *laissez-faire*. It is made for people of fundamentally differing views, and the accident of our finding certain opinions natural and familiar or novel and even shocking ought not to conclude our judgment upon

[334] See Jackson, *The Struggle for Judicial Supremacy*.

the question whether statutes embodying them conflict with the Constitution of the United States."[335]

On the surface, the fight between the executive and the judiciary seemed political; the president's liberal political agenda was blocked by the Court's conservative political views. But the tension ran deeper, addressing the incompatibilities of Classical Legal Thought and judicial supremacy with the emerging liberal ideology and socioeconomic realities of the 1930s. Put simply, Roosevelt, like the Legal Realists, saw that as long as the Court and its conservative common-law interpretation of the role of the state in the economy remained unchanged, so would the increasingly untenable conditions of income inequality and general poverty plaguing his country. US law, as interpreted by the Court, no longer acknowledged the realities of US capitalism. Worse, it contributed to increasingly undemocratic outcomes (e.g., inequality and corporate oligarchy) by means of a just-as-undemocratic judicial supremacy (explained above). Roosevelt was thus fighting a battle not simply based on power politics but also on fundamental principles of governance.

Assistant professor of politics at Princeton University, Keith E. Whittington, explained that the conflict was part of a greater attempt by Roosevelt to democratize society and the government. Diminishing Court authority, increasing executive authority, and promoting his New Deal policies were equally necessary for Roosevelt to realize his conviction that "the government was to be the custodian of the whole people and responsive to the whole people."[336] So when Roosevelt attacked the Court, he did so as part of a larger attack on interests who opposed his notion of changing the government to respond to the social and economic realities of the US public. Whittington explains: "To the president, the Court was allied with a broad array of entrenched and elite interests that he would have to be overcome in order to achieve the new constitutional order that Roosevelt envisioned."[337] Without explicitly denouncing (as yet unnamed) Classical Legal Thought, Roosevelt recognized it in contending that these "entrenched interests" had promoted an interpretation of the Constitution that suited their private needs; it was his intent to reverse this trend and "unleash the political power created by the Constitution to promote the welfare of the people."[338] To "unleash" this power, Roosevelt had to not only propose his set of New Deal policies, but also to eradicate the primary ideological and structural obstacles in its way: Classical Legal Thought and its powerful Supreme Court proponents.

Roosevelt thus argued that the composition of the Court must be altered to ensure that judicial action was limited to the legal sphere, and thus removed from its current "supreme" position among the three branches of government. "If democracy were

[335]Justice Oliver Wendell Holmes, *Lochner v. New York.* 198 U.S. 45 (1905), 75–76, quoted in Jackson, *The Struggle for Judicial Supremacy*, 56.

[336]Keith E. Whittington, "Presidential Challenges to Judicial Supremacy and the Politics of Constitutional Meaning," *Polity* 33, no. 3 (Spring, 2001): 377.

[337]Ibid., 380.

[338]Ibid., 381.

to succeed, then the president had to have the power to 'appoint Justices who will act as Justices and not as legislators,'" as Whittington frames Roosevelt's words. While the Court-Packing bill that would have permitted Roosevelt to appoint additional, liberal justices to the Court did not ultimately pass, it nevertheless yielded the desired effect. Not only did one of the conservative "Four Horsemen" retire from the bench that year, breaking up the conservative coalition that had previously stymied Roosevelt's New Deal legislation, but the Court began to actively support the liberal order envisioned by Roosevelt, upholding the Social Security Act of 1935 and reversing its prior rulings against minimum-wage laws. The most powerful proponent of Classical Legal Thought—the Supreme Court—had finally changed its ideological course; Legal Realism, federal regulatory power, and liberal welfare policies could finally come to the fore to reflect and reshape the socioeconomic realities of the United States in the 1930s. Moreover, US capitalism could now shift away from its old, oligarchic model and toward a more egalitarian one.

Yet 1937 failed to provide a permanent solution to a problem deeply rooted in US law and capitalism. As argued earlier in this section, the foundations of Classical Legal Thought and the supremacy of a conservative judiciary lay in an early and ongoing suspicion of state power, written into the Constitution and furthered by legal advocates of the inalienable economic rights of individuals implied by common law, e.g., property and contract rights. Justice Jackson underscored this persistent problem and the potential re-emergence of tensions similar or even identical to that between Classical Legal Thought and Legal Realism, albeit by other names, in the future: "At the moment [1941] the Supreme Court is, in general outlook, the most liberal of any court of last resort in the land. Satisfaction with its present attitudes, however, must not obscure the fact that the struggle has produced no permanent reconciliation between the principles of representative government and the opposing principle of judicial authority. The Court has renounced no power and has been subjected to no new limitation. The effect of the attack was exemplary and disciplinary, and perhaps temporary."[339] As the next chapter will show, Jackson was not far off the mark in expressing concern for the persistence of the fundamental tension within US law would re-emerge to reshape US capitalism back toward an oligarchic model.

Conclusions

The 19th century was a remarkable success for the US economy in terms of geographic expansion, consolidation, urbanization, industrialization, market integration, and growth in per capita incomes. At the same time, the nation's economy was transformed from arguably the most egalitarian in the world into one that was radically more unequal in its distribution of wealth and power, to the point that the government's role as a legitimate governor in its capitalist system was compromised. With this background the chapter set out to explore two sets of questions,

[339] Jackson, *The Struggle for Judicial Supremacy*, vi–vii.

which I will repeat here: First, how was US capitalism transformed to permit a huge increase in the concentration of economic power in the hands of an economic oligarchy with consequent economic, social, and political inequalities by the end of the 19th century, and to what extent was the transformation facilitated by human agency in legislatures and courts, as contrasted with the natural forces of the growing national market, the Industrial Revolution, and firm structure? And second, how adequately was the economic oligarchy held accountable to the United States' young democracy, and why?

Question One: The Transformation of US Capitalism Toward Economic Oligarchy, and the Respective Roles of Natural Forces and Human Agency in the Process

Alfred Chandler provides a persuasive analysis of the rise of these new firms as based upon the technological imperatives required to manage the new technologies that harnessed new sources of power. The railroads, for example, harnessed the power of steam to drastically reduce travel times and costs. These declining times and costs, in turn, created the possibilities of huge economies of scale and speed, thereby permitting the integration of the domestic market. Chandler stresses the importance of those economies based on speed of production, first in the spinning and weaving in textile mills and then more emphatically in the speed of transport on the railroads. These technology-based economies created huge opportunities for increased cash flows, profits, and economic power.

But why were these new technologies coordinated through firms rather than markets, where the power would presumably have been much more dispersed, as in accepted theory? The new industries emblematic of the Industrial Revolution, such as the railroads, were characterized by increasing economies of speed and scale. If a firm could master the complexities of these new technologies, it could capture these economies of speed and scale within the firm. Chandler's great insight was that the visible hand of management could be superior to the coordinating role of markets in those industries with technologies mandating great scale or speed, or both, as with the railroads.[340] It took a new form of organization to permit this coordination, one permitting the integration of a sequence of functions subsequently known as the vertically integrated firm, as explained in Chap. 2, and again earlier in this chapter.

Chandler explains that the economies of scale could be achieved only through high levels of capacity utilization and thus high levels of coordination to maintain a steady throughput of raw materials and semi-finished goods. In facing the challenges of managing these new technologies, professional managers pioneered a

[340] Chandler, *The Visible Hand*, 82, 8, 12.

new, vertically integrated form of organization where professional managers could plan, coordinate, and in effect integrate the actions of many people through a hierarchy and on the basis of precise schedules to achieve internal economies of scale and speed. In addition, such a hierarchy gave managers the capacity to plan and invest ahead of demand in new areas and new technologies. Business historians have found Chandler's analysis compelling in describing the rationale for the giant firms that led this industrial transformation. However, Chandler does not prove the nature of these economies in any rigorous way. They could have come, at least in part, from the market power that went with local or regional monopolies or from the lobbying powers that went with large cash flows and abundant access to legal expertise. Furthermore, Chandler makes little attempt to explore alternative explanations for the exact nature of the power of these firms.

Charles Perrow, while recognizing the economies of scale and speed in Chandler's model, explores a partially competing hypothesis to the effect that much of the credit for the growth and success of these large enterprises was based on institutional innovations that permitted and even facilitated the acquisition of market power, as distinguished from any imperatives based upon economies in production or distribution. In his view much of the rationale for the size of the new giants was created by the federal judges and state legislators who made the legal decisions permitting the empowerment of these firms. Granting firms the status of a legal entity apart from its chartering authority in *Dartmouth v. Woodward*, and having states authorize charters of indefinite duration for any line of business activity, allowed firms to do things that no individual or small group could hope to accomplish. In addition, state authorization of charters that allowed the mobilization of capital from thousands of savers, and its indefinite lock-in by the firms under control of their own boards, tilted US markets to favor the interests of capital, relative to labor, and large-scale capital at that. Furthermore, the capital of shareholders was protected through the institution of limited liability in the event of bankruptcy or fraud.

This tilting of market frameworks facilitated the mobilization of capital from thousands of investors for indefinite periods, thus helping generate great economic power. It meant that corporate power could be focused on a single target for an indefinite period of time, such as a competitor or a group of workers attempting a strike, and this power could be used to reduce prices on a product or in an area with the intent to cripple or destroy a smaller firm. In a context of continuous immigration, this same focusing of power provided firms the opportunity to formulate wage policies somewhat similar to the East Asians after World War II, as described in Chap. 12, i.e., depressing wages to boost profits. Immigrants could be used as strikebreakers, enabling firms to have higher profits and cash flows and thus more robust expansion. Workers who protested or attempted a strike were risking their jobs. To think of labor markets as consensual bilateral coordinating mechanisms once large-scale immigration began in the 1870s, as Friedman might have us suppose, is to overlook the gross inequalities of power afforded by the scale and focus of a hierarchy bargaining with unorganized and vulnerable newcomers.

Firms were permitted to exploit their power through self-selected hierarchies with progressively less accountability to any power-granting authority as time went on. The notion that markets were an independent form of governance, irrespective of a lack of regulation, meant that highly unequal bargaining conditions were not to be subject to remedial political action or judicial review. State legislators added to these imbalances by providing additional sources of capital in the form of huge subsidies to those who would build railways. New laws and institutions, new technologies, and a continuous flow of immigrants reshaped US capitalism in favor of large-scale enterprise, enabling these new firms to wield power above and beyond the requirements for their normal economies of operation.

Perrow also takes note that business leaders were not just passive respondents to the new opportunities provided by US capitalism. Organized business interests played an active role in shaping the US political and legal context, enabling a small number of entrepreneurs to amass great economic power even at the expense of bankrupting others. For instance, railroad firms pursued horizontal mergers after 1890 as a strategy for building market power; the larger these firms were, the better they could create and protect regional monopolies as well as make acquisitions to control long-distance traffic. Increased scale greatly enhanced the political power of these same firms and thus the possibility of more favorable treatment from the public authorities. Securing permission from the New Jersey legislature to purchase shares of other firms is a prime example of business manipulating the political and legal systems for its own advantage, as were the cases of forestalling rate regulation in California for decades and the promoting of business-friendly representatives to the US Senate. The record seems clear that the railroads were leaders in stifling and subverting federal as well as state regulation, either directly through bribes and more subtle political support to legislators or indirectly through persuasive, laissez-faire legal arguments, as indicated not only by Perrow but also by Beard, Buenker, Burt, Horwitz, Phillips, Prechel, and Urofksy—each of whose work contributed to this chapter.

Morton Horwitz's analysis of this period is similar in thrust to that of Perrow, but the former surveys the impact of the legal system as a whole rather than focusing on a few key decisions. Horwitz points out that though industrial policies were usually thought of in terms of tax breaks or subsidies requiring legislative approval, similar effects could be achieved by judges reshaping property rights and prioritizing the sanctity of contracts, thus effectively changing the market frameworks themselves.[341] In this vein he points out that judges of the newly independent United States shaped the legal system to implicitly subsidize economic growth through the construction of property rights, contracts, and thus markets. Judges denied the right of a state to limit the hours worked by children or women, as well as those of the bakers in the *Lochner* case, not to consciously favor business but rather to prevent political authorities from infringing on the rights of employees to bargain freely

[341] Horwitz, *The Transformation of American Law, 1780–1860*, xv.

with employers. The unexamined assumption was that the market framework was correct because what else could it be?

Horwitz also notes that the empowerment of US firms was profoundly influenced by a gradual transformation, by human agents in the legal field, in how the law defined the origins and therefore the accountability of the firm. As he explains, courts took an increasingly liberal approach to corporate law, moving from the Grant Theory of the early 19th century under which the states created corporations for a public purpose, to the Free Contract Theory of 1850–1870 under which the requirement of a public purpose was removed, to the Natural Entity Theory of the late 19th and early 20th centuries, under which the assumption of state creation of and therefore regulatory power over firms was removed. Through over a century of legal opinions—from *Dartmouth vs. Woodward* to *Santa Clara* to *Lochner*—Horwitz shows that the US Supreme Court played a key role in redefining the corporation from a creature with specified and limited powers created by and therefore accountable to the states, to an independent entity, a free individual with no evident accountability to any higher authority in terms of the scope of the activities that it might engage in. Firms could be held accountable for their actions through federal regulatory authorities such as the Interstate Commerce Commission and then the Justice Department under a succession of antitrust laws, but in terms of its sense of purpose this was entirely up to the governance process of the firm.

Given these accounts by Chandler, Perrow, and Horwitz, it seems clear that the rise in the power of firms was not based primarily upon the increased specialization of labor envisioned by Adam Smith in his notional pin factory in the 1770s or by de Tocqueville on his visit to America in 1830. Nor was it created in the markets envisioned in classical economics, with its emphasis on the decreasing economies of scale and therefore self-regulating nature of competition. Small, specialized firms competing in highly competitive markets where they had little or no pricing power were indeed characteristic of the bulk of US firms and industries of the 19th century, but emphatically not of the new firms and industries that amassed the power to create an oligarchy. The power of these new firms was the joint product of the new technologies of the Industrial Revolution, a new form of organization that permitted management to coordinate vertically integrated flows of raw materials and semi-finished items within the firm through a managerial hierarchy, and the corporate autonomy established by a transformed legal system that granted them charters permitting them to reach any size in any number of businesses, thus allowing them to have the pricing powers of oligopolies. At the same time, this legal system also granted their shareholders limited liability and their entrepreneurs the right to create self-governing structures managed through self-appointed hierarchies without any corresponding accountability to society beyond the payment of taxes. Furthermore, these firms were permitted to lobby governments, state and local, to subvert the tax system in their own favor and to subvert competition to charge prices reflecting their market power. Ironically, then, these firms were permitted to develop within and eventually dominate the US capitalist system, infiltrating even the democratic institutions of its three-level structure of governance.

Question 2: The Transformation of US Capitalism: to Hold, or Not to Hold, Its Economic Oligarchy Accountable, and Why

From the founding of the nation until the late 1830s, the constitutional dispensation of regulatory powers was arguably adequate. By 1800 the country already had 16 states that could charter firms to participate in the national market, but the vast majority of these firms were too small to serve a market as large as a state, and certainly not a large state such as New York or Pennsylvania. States granted charters with specific conditions in them, and state powers were surely adequate to monitor firms in their markets, unless they happened to be on navigable waters. Thus, the regulatory system was broadly effective even if the powers of the federal government were barely called into play.

However, this effectiveness quickly declined once the *Dartmouth v. Woodward* decision granted the legal rights of independent entities to corporations and the Industrial Revolution made it possible for private actors to develop and control the new technologies of power generation and distribution, and a legal revolution made it possible to charter firms that could lock up the funds of hundreds and then thousands of investors indefinitely, while these same shareholders were protected by limited liability as well as the possibility of exit through public stock markets. The emergence of general charters without conditions, legally justified by the Free Contract Theory, helped induce the creation of much larger firms much more rapidly than before, when a special act of the legislature was needed. And the new legal powers and protections granted to the firms and their shareholders respectively meant that firms wielded powers far greater than those ever before held in private hands. In addition, large firms were, in turn, able to exert hierarchical power over the working conditions of their employees in the labor markets, pricing powers over smaller firms in the product markets, and oligarchic political power at both the state and federal levels, thereby subverting the electoral markets to achieve private gains at public expense. The system was no longer adequate to countervail the power of large firms, let alone business lobbies.

Thus, the Constitution created what amounted to a very lightly regulated common for what would be, by 1900, the world's largest, richest market, and home to many of the world's most powerful firms. And, as US industrial firms developed, states raced to the bottom in granting them powers without any corresponding responsibilities. Competing for employment and registration revenues from firms, states increasingly relaxed their charters' conditions; the limited charter was replaced first with the general purpose charter, granting firms the status of legal independence to participate in any sector or location that they might choose, and then with a charter adding the protection of limited liability, granting firms a right that natural persons did not have. Firms were further empowered by the Contracts Clause of the Constitution, which forbid the states from interfering with the terms of a private contract and thereby gave credence to the notion that private purposes came ahead of those of society as a whole. Moreover, the Fourteenth Amendment, as interpreted by the Supreme Court, made it possible for firms to challenge any state regulation to show that it had followed due processes in substance as well as in legal form to the satisfaction of the courts. This meant that a wealthy firm had two chances to win a dispute, once in the legislature and a second time in court, and the delay could stretch on for many years. Furthermore, substantive decisions not in conformity with a laissez-faire conception of capitalism were routinely found unconstitutional, as Justice Holmes and Solicitor General Robert Jackson would point out.

The firm thus became more powerful than any public organization or individual person, in terms of economic resources and most importantly legal rights. Historian Maury Klein sums up this incredible empowerment and resultant power imbalance as follows:

> The emergence of corporate giants began in the 1880s and soon unbalanced the entire social system. Given its narrow purpose, the corporation could bring to bear all its resources on any specific action needed to achieve its goal, and it could do this for an indefinite length of time. No individual could do this, and no public institution had ever displayed the same drive or single-minded focus. Many Americans complained that in transcending human limitations the corporation had also transcended human restraints. Even some of the great entrepreneurs worried over what they had wrought. "A great business is really too big to be human," declared Henry Ford. "It grows so large as to supplant the personality of man. In a big business the employer, like the employee, is lost in the mass."[342]

In terms of size and power, businesses far surpassed any and all individuals and firms at the time and, indeed, eclipsed even the federal government. By 1893, for instance, US railroad firms earned more income than the US government; taken together, these firms earned about $1.1 billion in revenue that year, while the federal government collected no more than $386 million in revenue.[343] Such an imbalance in disposable funds was alone a clear indicator of the incredible and ever-increasing imbalance in power between the private sector and the government by the end of the 19th century.

This increase in power beyond that of any other known organizational or individual entity was exacerbated by—and quite arguably also caused—the lack of constraints placed upon it by regulators. External regulation came from the federal government, but it was limited by the Constitution and dependent upon external regulatory agencies such as the ICC or the Anti-trust Division of the Justice Department to enforce ultimate accountability on the firms. The efforts of these agencies' generally had very limited success since it had to have the assent of the Senate which had an organized, bipartisan phalanx of Senators that insisted on a pro-business, anti-labor slant to most business legislation. It proved exceedingly difficult to pass legislation that could provide meaningful external standards of conduct or performance, and without a federal chartering system, internally imposed standards of business conduct or performance imposed little accountability.

In short, there was a growing imbalance between corporate rights and corporate responsibilities. Some external authority—an agency of the federal government—ought to have licensed firms to participate in interstate commerce but on the condition that these firms acknowledged that their license to operate came from

[342] Klein, *The Genesis of Industrial America, 1870–1920*, 134–135.
[343] Ibid., 134.

a political authority and not their shareholders and that this license or grant subjected them to a number of conditions. For example, Wickersham's 1910 proposal for federal chartering required annual reports based upon strict standards of financial accounting, similar to the requirements established 25 years later by the Securities and Exchange Commission. More significantly, Wickersham's proposal included provisions to prohibit firms from entering into banking or from buying or holding stock in firms chartered in other states. At a minimum, the latter would have impeded further expansion of firms via holding companies and horizontal integration, a trend catalyzed and propelled by liberal state chartering powers in the late 19th century. Though probably too late to undo the rash of mergers and acquisitions since 1890, such legislation could have at least made any further consolidation conditional on Justice Department affirmation that the merger in question would not unduly reduce competition in the industry. In this way, federal charters would have held firms accountable for their behavior in a top-down governance system.

Thus, the Grant Theory of the early 19th century would have prevailed over the Free Contracts or Partnership Theory of the mid-19th century as well as the Natural Entity Theory of the late 19th and early 20th centuries; firms would have clearly owed their existence not to their shareholders, nor to some form of spontaneous generation, but to a federal or state authority. Since firms owed their powers of lock-in of shareholder capital to such authorities, and the protection for their shareholders as well, it seems remarkable that the legal profession could somehow submerge the true source of legal authority of the firm in favor of a form of mysticism to the effect that markets and indeed capitalism came before the existence of government, a proposition that flatly contradicts my understanding of the history of capitalist development, as well as the notion that capitalism, like democracy, is a socially constructed system of governance. Additionally, a system of federal chartering would have served as a reminder that firm privileges such as limited liability and hierarchical organization were granted by the state and were not "natural" rights generated by the markets.

Federal chartering of non-financial firms was not established (and never has been). Given this void, the law came to treat firms as autonomous entities emerging and operating independent of the state. This treatment fit well with what Horwitz identifies as the dominant Free Market ideology of the time; the laws of the "self-executing, decentralized, competitive market economy"[344] that were thought to have rightly severed any hierarchical connection between the state and the firm. The firm was a legal "person," behaving according to the "natural" laws of economics (i.e., self-interest) and enjoying general freedoms of choice with no legal obligations to serve a public purpose in return for its grant of power.

State governments were unable to halt this train of events. As the assets and operations of the new industrial and transport firms grew relative to the powers of the states that had chartered them, states were not only constitutionally but also practically unable to regulate such interstate commerce. Firms—and their tax

[344] Horwitz, *The Transformation of American Law, 1870–1960*, 194.

revenue—would relocate to whichever state most favored their unrestrained use of the national common. Indeed, states were soon in a race to the bottom in terms of leniency of the standards for incorporation in order to attract more firms, early on in the case of granting of limited liability and most evidently in the case of granting the right to buy shares in other firms, as initiated by New Jersey. The latter case opened wide the gates to create giant firms with great market power; as Perrow notes, New Jersey's legalization of the holding company led to "3,653 mergers between 1898 and 1902, twenty-five times the number in the succeeding five years."[345] Furthermore, with this change it was possible to create firms that were more powerful than state governments and even the federal government, thus paving the way to oligarchic capitalism.

As long as the federal government lacked an explicit and exclusive constitutional mandate to charter or license firms to operate in interstate commerce, it was missing a vital tool to stop the growth of this corporate oligarchy at its source. Various regulatory measures were adopted (e.g., the ICC Act of 1887, the Sherman Antitrust Act of 1890, the Mann-Elkins Act of 1910, and the Clayton Act of 1914, among others), but all had to pass through the US Senate, where a powerful business lobby watered each remedy down to a very thin slice of its original purpose. In addition to opening the way for oligopoly in many industrial sectors, failing to acknowledge the chartering power was a powerful contributing force in the subsequent distortion of the notion of capitalism. These circumstances would lead Perrow to conclude that by 1910 the United States had been set upon a path that welcomed giant enterprises from which there would be no turning back.[346]

The prevailing legal theory of the time, Classical Legal Thought, conceived of capitalism as a system of markets guided by the invisible hand of market forces, as though it reflected the results of some natural science, independent of the visible hand of any political authority. Over the 19th century, this counterfactual, ideologically biased version of capitalism, based on the notion that somehow markets preceded both laws and political authorities, came to affect court decisions at the state and federal levels and ultimately to dominate legal theory. It meshed quite naturally with neoclassical economic thought, which presumed that firms were responsive to markets, and thus that firms exercised little independent power of their own. Both realms—law and economics—failed to recognize that capitalism is a governance system for the control of economic power. It is a societal construct and not one based upon natural laws like physics or biology. Both law and economics defined the firm as independent from political authority, thereby helping to set the stage for pernicious court decisions like *Lochner v. New York* that treated market outcomes—however coercive in reality—as based upon voluntary transactions among private parties and therefore immune from review and modification by the state legislature. Similarly, the entrenchment of this distorted definition of capitalism contributed to the artificial narrowing of a field of study then known (i.e., in

[345] Prechel, *Big Business and the State*, 64.
[346] Perrow, *Organizing America*, 3.

1900) as political economy to a new field of economics, giving less and less attention to institutions and virtually ignoring the role of political markets and political authorities in the governance of capitalism. Holding firms—or any market actor for that matter—accountable to an external governing authority became the exception and not the rule.

Attempts to establish accountability through an internal, bottom-up governance system fared no better. A shareholder-oriented, bottom-up system was, and remains to this day, a very imperfect solution. Shareholders in a firm whose stock is publicly traded need not have any long-term commitment to the firms in which they invest; they can trade in and out as would a speculator. This contrasts with shareholders in privately held firms where there is no established public market for the shares. In this latter case the shareholders have a time horizon that is of necessity longer term because their shares are not readily marketable. As a consequence shareholders in a public firm do not automatically deserve to be considered "investors" or owners at all; they might be better thought of as bettors or speculators.

US corporate laws were initially written at time when firms were overwhelmingly privately owned and controlled. Shareholders in a private firm might well raise personal capital to help the firm through times of trouble, while those in a public firm might be more likely to quickly sell their shares. Even were the latter set of shareholders to take a longer-term interest in the firm, they could rarely act on it; shareholders in publicly traded firms generally have little voice in communicating their preferences to management as they are relatively powerless given both the great number of individuals owning shares and the deeply entrenched position of managers in the firms' internal hierarchies. CEOs, once elected and entrenched, enjoy the power to exclude directors from consideration for reelection, and thus rather extraordinary powers—except in a crisis. Shareholders do indeed have to ratify the slate of directors proposed by management, but they cannot normally nominate candidates for directorships in an open contest for board seats. Thus, in public firms, directors have limited power except in unusual circumstances. To dissent on major decisions may be to say I resign. In addition they have little real accountability to the principals that they are supposed to represent, again except in a crisis. Their value in governance depends a great deal on their personal sense of responsibility and integrity, and on their willingness to invest the time needed to understand the nature of the business and its challenges.

Lacking the restraints of an effective system of external or internal accountability, top managers of large firms had (and have) great latitude to exercise power, both inside the firm through hierarchies and outside the firm in the political and economic markets. Market power created the opportunity for these managers to try to manipulate both sets of markets for their own advantage with little regard for the interests of society. As a result an oligarchy came to dominate US capitalism and also its democracy by the early 19th century. This oligarchic role for business leaders was implicitly supported by prevailing legal theory, as scholars and justices of the Supreme Court generally followed the doctrines of Classical Legal Thought, freeing the firm from any evident external accountability for the extraordinary powers that it had been granted by society. In this laissez-faire context, state legislatures could easily be manipulated, either directly through bribes or political favors or indirectly through the race to the bottom among the states in setting regulatory constraints, as described above. Even the federal government was not free from their influence, with the Senate similarly subverted and corrupted by increasingly wealthy, powerful firms. It took a Great Depression, during which firms were greatly weakened and a sense of national crisis prevailed, and ultimately World War II, to bring reforms that could halt the rise in corporate oligarchy and redress some of the resulting inequalities.

As I argue throughout this chapter, this progression toward increasing oligarchy is partially, though not entirely, rooted in the US Constitution. The Constitution's clauses failed to grant the federal government effective political power to govern the national common, i.e., the commercial space of the US market. If such an authority had existed and been appropriately employed before the 1890s (e.g., before the merger movement), it could easily have helped to maintain the Grant Theory of corporate powers over the ahistorical and allegedly apolitical Natural Entity Theory. States' race to the bottom, the resultant merger movement, and the ultimate corporate corruption of political bodies, might have also been avoided. If this had happened, US notions of corporate governance might well be much closer to those in Europe today.

But most important of all, if the Constitution had created a formal political authority over the national common, later US law might well have recognized that politics and economics, society and the law, and human agency and corporate power are inextricably intertwined. Even establishing such an authority years later, via a federal licensing or chartering system and a popularly elected Senate, might still have influenced legal doctrine to better reflect reality and thus better protect the national common from a corporate free-for-all. Of course, the longer the national common remained unregulated by such a political authority, the more powerful the firms became economically and politically, and the harder it would be to mobilize the political power needed for the appropriate reforms.

Thus, the United States entered the 20th century under the sway of a corporate oligarchy whose power perpetuated a narrow and distorted conception of capitalism that was built on the highly artificial notion that economics and politics are and ought to be distinct. As referenced in this chapter, Horwitz, Kennedy, and Perrow called attention to the rise in corporate power with limited not to say inadequate accountability. However, for want of an explicit definition of capitalism, let alone a robust definition of capitalism as an indirect system of governance, even these authors[347] seem to have underemphasized the fact that the prevailing doctrine of Classical Legal Thought distorted the understanding of *US capitalism* itself.

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[347] Unlike the main authors on whom this chapter draws, Duncan Kennedy does explicitly acknowledge this connection, albeit without framing it in terms of capitalism, as I do here. Kennedy states that "Classical legal thought supported the fundamental analytic paradigm of classical economics in two ways: it offered a confused Lockean theory of property to complement the confused Ricardian labor theory of value, and it developed a will theory of contracts to complement the theory of the gains from free exchange. It responded to the problem of defining the prior role of the state in the economic system through the notion of legal science. . . . " My argument differs from that of Kennedy in that I demonstrate how CLT influenced a conception of US capitalism while

Classical Legal Thought supported a view of capitalism as a system governed more by the "natural" laws of "economic science" than by those of legislatures' enactments as interpreted by judges. This flawed understanding of capitalism gave firms, via their managers and their financiers, the opportunity to subvert both capitalism and democracy for their own narrow interests. By the end of the 19th century, they could easily abuse the largely unregulated US common for private gain at the public's expense. As long as these actors operated under what Horwitz calls "the assumptions of a self-executing market economy," any "unequal results were just," created not by self-interested individuals but by "the market process as a neutral and apolitical arbiter of the just distribution of wealth."[348] Because legal, economic, and political actors ignored the role of human agency—i.e., *their own roles*—in the development of US capitalism, they failed to prevent and, to an extent, even abetted the rise of this oligarchy within the nation's increasingly productive economy.

This situation was redressed in 1937, following President Roosevelt's confrontation with the Supreme Court. However, the Roosevelt Administration did not use this turn of events to try to unwind the oligarchic nature of US capitalism that Perrow had pointed to. By 1950 the US had a lion's share of the world's largest firms, and thus would be a spur to a "race for the top" in terms of size. However, if one asks whether US democracy had been able to reassert its governance role over US capitalism as a whole then the answer is clearly the opposite, i.e., it was able to pass labor legislation that drastically altered the tilt of US markets away from their previously pro-capital stance in favor of a softer approach much more like the West European states.

However, the 1937 settlement was based on a behavioral change by members of the Court, and not by a structural change imposed through legislation let alone a Constitutional Amendment. So, as Robert Jackson noted at the time, it was a change that might only be temporary. The effect of these events was to allow Congress to establish governance in a way that it had never enjoyed, and in a way that was more nearly parallel to European parliamentary practice. It would lead the United States to establish a welfare state with certain similarities to those that were emerging in Europe, and thus to have a much less distinctive form of capitalism, at least for a time. In the next chapter we will see US capitalism recaptured by the forces of Classical Legal Thought, but this time with a clear manifesto to guide their thinking.

Kennedy demonstrates how classical economic theory influenced CLT. (See Kennedy, *The Role of Law in Economic Thought*, 952–953.)

[348] Horwitz, *The Transformation of American Law, 1870–1960*, 194.

Chapter 14
The Transformation of US Capitalism and Democracy, 1965–2009

US capitalism in the period 1965–2009 drew on two distinct models: that of 1933–1980 and that of 1981–2009, and not just a single, gradually evolving model like that examined in Chap. 13. At the same time, the return to the laissez-faire regime after 1980 is only superficially based upon the familiar, but simpler, laissez-faire model of earlier times. The differences in the nature and extent of the deregulation in these two eras of US history have not been widely or deeply appreciated, and I aim to elucidate that difference in this chapter.

The laissez-faire model adopted after 1980 turns out to be radically different from its pre-1932 predecessors because US policymakers deregulated the social and political systems beginning in the late 1960s, with effects that I believe have been grossly underestimated. Thus, the deregulation of US institutions has spread far more widely throughout US society and been built in far more deeply into US institutions than at any other time in the 20th century and than in any other capitalist regime anywhere in the modern era. Identification and analysis of this broadened and deepened notion of deregulation is the first aim of this chapter. About a third of the chapter is devoted to explaining and interpreting the deregulation of the US social and political systems prior to 1980.

There are disappointingly few serious sources on economic deregulation since 1980 that took an appropriately broad view of the problem. In contrast, I found Fareed Zakaria's *The Future of Freedom* a remarkable source, more or less on a par with the depth and breadth of the writings of Alfred Chandler, Morton Horwitz, or Charles Perrow, all of which I relied heavily upon in the previous chapter. This created an unusual challenge. Zakaria describes the deregulation of the political system, but not that of either the social or economic systems. That has proven a very real challenge and the second aim of the chapter has been to achieve a more balanced analysis of developments in these three subsystems.

Furthermore, the transformation of the US systems of governance can only be partially accounted for by "macro" forces such as increasing powers of either government or firms. In this period government had immense powers, but had increasing difficulty bringing them to bear on the economic actors for reasons that Zakaria largely explains. But, at the same time, firms did not have a great growth in size or power, and overall were at least theoretically dwarfed by government. Yet, business rose to play a stronger and stronger role relative to government, and I attribute a

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5_14,

good deal of this rise of business power to changes in the internal governance of firms themselves, and particularly to their adoption of a notion of shareholder capitalism, which seems to me to have been in considerable measure a rationalization of a lust for increased power and wealth by a ruling oligarchy within the private sector. The greatly increased usage of stock options and other forms of incentive pay were justified in order to get management to do its job, while, at the same time, they were used to pay management far more just for average results.

However, there was also a formal change in corporate purpose during this period. In particular, I refer to the shifting of the purpose of the firm from the stakeholder model to the shareholder model, which legitimates a concentration of the rewards on a small elite, and a dramatic increase in the usage on incentive compensation for top executives. I found these changes associated with the spread of a culture of opportunism in the private sector, and increased willingness to ignore the costs of negative externalities for private gains. To evaluate these particular business practices, i.e., shareholder capitalism and stock options required some explanation of business practices which go well beyond the explanations of the operations of the vertically integrated firm and their putative economies of scale and speed in the previous chapter yet which have been largely omitted in other chapters. However, I believe that this excursion into some of the intricacies of business management will help the reader understand why US firms found it relatively easy to set aside public virtue in their search for higher levels of private gain. Given the importance of the US economy, this is a trend that affects capitalism throughout the world.

To understand the evolving relationship between capitalism and democracy in the early 21st century, we need to go back to the mid-1960s. Zakaria, in his *Future of Freedom*, noted something that many other researchers seem to have missed, namely, the fact that the United States began to deregulate its democracy not during the Reagan administration but in the late 1960s, well before the economic reforms of the 1980s, and to very profound effect, as we will see. In addition, he notes, but does not explore in any detail, the fact that the United States also deregulated much of its social system beginning in the mid-1960s. Thus, as he recognizes, the United States was demolishing many of its traditional bases of authority long before its economic deregulation got underway in the late 1970s and especially after 1980.

In my analysis of this material, I return to an idea from Lincoln's Gettysburg Address, introduced in Chap. 3, where he referred to "government of the people, by the people, for the people" as though government by the people was not, by itself, enough to insure government for the people. Indeed, that is the key distinction that I make in this section, i.e., that populist measures opened the political process for more participation but not necessarily through institutions that would favor the interests of the middle classes. While government became increasingly open and participatory, it could be hijacked by special interests so that it served the interests of well-defined special groups more than those of the public. As I intend to show, however counter-intuitive it may seem at first, open government of the type now practiced in the United States brings about the opposite result: the narrowing of government attention to only the special interests because of their powerful financial means, formidable organization, and a failure of the US educational system to keep up in areas such as history and social studies while it focuses on such "crucial determinants of competitiveness" as math, science, and English.

While Zakaria did not explicitly refer to Lincoln's idea, in my view he was remarkably perceptive in drawing what seem to me to be some profound implications of the deregulation of these US systems of social and political governance. Concluding his book, he wrote: "Eighty years ago Woodrow Wilson took America into the twentieth century with a challenge to make the world safe for democracy. As we enter the twenty-first century our task is to make democracy safe for the world."[1] But are all versions of democracy unsafe for the world, or only some of them?

Zakaria makes a powerful case that the efficacy of democracy as a system of governance has been imperiled because of "too much of a good thing," meaning excessive opening and democratization of its institutions and a corresponding "death of authority" among key social institutions. The most important changes that he enumerates amount to forms of deregulation of democracy, which implicitly turns governance over to its respective markets, i.e., primary and final elections, legislative votes, the initiative petition, and, of course, the legions of lobbyists. It amounts to more "government by the people" without concern for whether that makes it more *for* the people. At the same time, Zakaria's analysis of deregulating democracy and downgrading the influence of its structures of authority is entirely based upon one country, the United States. Other traditional industrial democracies did not share these experiences to anything like the same degree. Indeed, to my knowledge, no other industrial country has made a similar set of changes in its political institutions since World War II, and the country cases that I know best have not made the four political changes that he focuses on (i.e., opening primaries to any and all comers, allowing grossly unequal political contributions as a protection of "free speech," disempowering Congressional committee chairs and other structures in the legislature to democratize the leadership, and increasing the use of direct democracy via initiative petition and recall elections). Zakaria is generalizing from a single, albeit a very important, example.

If my interpretation of the facts is correct, then Zakaria's concluding thought might have been more accurately and even more perceptively written to state: "As we enter the twenty-first century our task is to make *U.S. democracy* safe for the world." The analysis developed in this chapter will suggest that the challenge Zakaria frames should be further expanded to the effect that "our task is to make U.S. *capitalism and democracy* safe for the world," which is still more difficult. I do not know if Zakaria would accept the merits of this much broader challenge, but I do believe that it is exceedingly important and even urgent to consider, and I will return to it in Chap. 15.

Raising these questions on the role of US capitalism and democracy in the world builds on the basic premise with which the book began, i.e., that the two

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[1] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 256.

basic systems of governance in the contemporary US—capitalism and democracy—are inescapably interdependent, and neither can be transformed without affecting the other. Furthermore, capitalism cannot be transformed as a governance system except through the political process. Thus, the political authority of US democracy is required not only for the shaping of democracy itself but also for the shaping of US capitalism; the two systems share a single governing entity and depend on its ability to function both legitimately and effectively in both realms. For me, the foremost question at the end of this analysis is whether the United States has a set of democratic institutions that are capable of achieving the reforms that are needed in either of its governance systems, let alone both, and even from a domestic standpoint, let alone equal to what other countries might expect or perhaps hope for from the United States in the decades ahead?

Outline

This chapter recounts the re-emergence of the so-called free market, laissez-faire model of capitalism and the return of oligarchy during the last quarter of the 20th century and beyond. In telling this story, it points to a growing ascendancy of the power of private business interests relative to that of the political authorities that are charged with their regulation, a story that seems reminiscent of the 1880s and 1890s and their aftermath. However, in this more modern context, the reason for the divergence of private power and accountability in US capitalism has not been due to technologically driven increases in that private power, as happened in the 19th century; rather, this chapter will argue that the growing ascendancy of private power has been primarily due to a decrease in the regulatory powers of government on the one hand, and the reduced willingness by relevant political and regulatory authorities to use the powers that they did have on the other.

In the 19th century, the prevailing notion of appropriate regulation among US leaders, in politics as well as business, was built on what Duncan Kennedy has called Classical Legal Thought. A central notion of Classical Legal Thought was that economic activities should be absolutely free from political influence, unless the issue affected everyone such that political action would be devoid of any favoritism. In other words, sovereignty rested with markets or the first level of the capitalist governance system, rather than with political authorities, or the third level. No distortions or inequalities by sector or profession merited interference with market outcomes unless they adversely affected almost everyone. A prime example of that strategy is the *Lochner* case, discussed in Chap. 13, which ruled that the state had no right to intervene to protect bakers from accepting contracts for a work week in excess of 60 hours so long as it was a "voluntary" contractual relationship.

As I see it, Classical Legal Thought has re-emerged in the 20th century, taking the form of the neoclassical economics developed by Milton Friedman and the so-called Chicago School, and then extended into Law and Economics, a new academic discipline. Just as Classical Legal Thought prevailed among the legal minds of the 19th century, the ideas of Milton Friedman, Ronald Coase, Douglass North, and Richard Posner exerted a sway over academics and regulators in the late 20th century. This re-emergence of laissez-faire ideology promoted the idea that the regulations that had been imposed from the 1930s through the 1970s should be reduced and, where possible, abolished. Thus, my main proposition in this chapter is that free-market ideology supplied the strongest impetus for the transformation of US capitalism back toward a deregulated and quasi-laissez-faire model of capitalism, with little regard for the considerable increase in complexity of the economy in the meantime or, indeed, the deregulation of the social and political systems that had taken place, mostly in the 1970s.

By the time this movement to re-establish the laissez-faire model blossomed in the 1980s, US society had been transformed by the social and political revolutions of the 1960s and early 1970s. The deregulation of the 1980s was not a reversal of existing trends so much as an extension of those ideas, albeit from different ideological origins. In reality the deregulation movement had already radically transformed the US political and social systems, a circumstance that is often overlooked. The deregulation for which the Reagan administration is so well known came after a turbulent and sometimes violent process of stripping authority out of many organizations and institutions. The United States was already suffering from a shortage of governance throughout the country as the Reagan deregulation initiatives began. What had formerly been a social system based upon often, though by no means always, flawed institutions was being replaced by a new panacea, governance by markets, unencumbered by the vagaries of any sort of political authority. In the new, reformed scheme of things, the new standard of societal value for almost everything could be calculated in a single objective measure: the dollar. Commerce was no longer a means to an improved standard of living; it was the end in itself. Money was not just a store of value or a measure of value; money was the supreme arbiter of value and its accumulation the key measure of success for many.

Taking into account the challenges noted above, and the far-reaching nature of the US transformation from 1965 onward, this chapter proceeds as follows: First, I discuss the context in which these changes marked a departure from the previous period, i.e., from the 1930s to 1980. I present data indicating that a notable change certainly did occur at the two break points highlighted by these chapters on US history, one in the 1930s and the other around 1980. I further suggest that the United States was one of a small group of industrial countries to experience the second change, as most other developed countries, particularly those in Europe, continued with some variant of the social democratic capitalist model developed in the 1930s.[2]

In asking why this second change occurred, I turn to the mid-1960s and to a discussion of the first of three elements in what I dub a "toxic trio," which contributed to the return of US capitalism from its mid-century social democratic model to the

[2]The United Kingdom and Canada, two other English-speaking countries, also experienced this second change, but to a much smaller extent than the United States. I leave them out of the story for the sake of simplicity and brevity.

earlier laissez-faire model. This identification of a toxic trio is not intended to suggest a comprehensive analysis of the causes of the transformation; it is rather a means for me to succinctly suggest the interconnected nature of some of the powers unleashed by this transformation, powers that were initially more social and political than economic. Put simply, the toxic trio is comprised of: (1) *Deregulation,* which, in my view, was initially social, then political, and only then economic, from the late 1970s; (2) the emergence of *shareholder capitalism,* backed by the mantra that managers should be the agents of the shareholders, as though the shareholders were the owners and principals in whose name firms were to be managed, with little regard for the elected governments who had chartered the firms to use certain extraordinary powers not granted to other individuals; and (3) the greatly increased reliance and indeed institutionalization of one-way, upside only *incentive compensation*, particularly in the form of stock options, as a way to motivate CEOs and a few senior managers to be paid like "owners," without risking any of their own capital.

I see this trio as self-reinforcing. Deregulation weakened or removed guidelines for behavior that had served as pillars of stability; as a consequence it increased the possibilities for economic actors to test the rules of the system for new loopholes that could be exploited, while shareholder capitalism concentrated the gains for those who succeeded. It was a powerful recipe to motivate ambitious people to subvert the system for their own private advantage. It was institutionalized through the formative roles of business schools and economics departments into a social system for the promotion of opportunism, as though opportunism was synonymous with promotion of the public good via that hallowed institution, the invisible hand.

I begin with deregulation, the broadest of these institutional changes, in order to explain how the notion of free markets returned to the forefront of American thought and practice, and on a much broader scale than in previous US history, and indeed perhaps in any other country in the post-World War II era. The exposition of the three different forms of deregulation—social, political, and economic—occupies approximately one third of the chapter. I trace the rise of deregulation to the emergence of social, political, and economic instabilities in the United States in the 1960s. While all the developed countries faced similar economic instabilities, the United States was a special case among the developed countries in the intensity and range of its social and political instabilities, starting from the instabilities associated with societal protests against segregation or institutionalized racism. With this background, I outline how the notion of self-regulation, or the removal of traditional standards of behavior (which were seen as tools of racial prejudice, sexism, elitism, and/or protection of privilege), in favor of market-based standards, became popular in the social, then the political, and, finally, the economic realms. Deregulation became a means to promote greater freedom and democracy in the minds of academics, policymakers, and the public, and free markets thereby became the basic locus of governance. Obviously, the freedoms associated with desegregation and the freedoms associated with laissez-faire market capitalism are not the same thing, nor did one necessarily lead to the other. In fact, it may even be that the prophets of laissez-faire capitalism *piggybacked* on or even *highjacked* the rhetoric of freedom pioneered by the civil rights movement of the 1950s and 1960s. Right-wing economists of Chicago and elsewhere talk about "freedom" and "liberty" all the time, as if they were Martin Luther King. But as I pointed out in Chap. 2, Friedman's notion of freedom was freedom from government interference; it was not the kind of freedom to develop opportunities that comes with an education and the prospect to find a job where there were possibilities for human development. Thus the civil rights movement wanted to avail themselves of the powers of government to promote opportunities for human development while right-wing economists wanted to weaken the state's enforcement powers to regulate the economy, including its powers to create or strengthen just such opportunities. Both sides used the rhetoric of freedom, and both were ready to attack structures of authority, albeit with different underlying reasons. Over time freedom and deregulation became panaceas, while structure and authority became bogeymen. It created a natural environment in which money could become the "neutral" arbiter of value.

Next, I turn to the second and third institutional changes of the toxic trio, which, I argue, emerged in part due to the deregulation of the economic sphere, and more specifically to some very bad theories absorbed from the academic community. These two institutional changes were the emergence of shareholder capitalism to supersede stakeholder capitalism, and the overwhelming adoption of incentive compensation, particularly in the form of stock options, at least nominally as a key means to promote superior performance among top executives. These two institutional changes are tightly linked: incentive compensation became a tool for ensuring the actuation of shareholder capitalism, and, together, the theory and the practice underscored the rise of markets as the primary governing authorities within firms in preference to salaries and other less tangible forms of rewards. I conclude this section by drawing upon the writing of Sumantra Ghoshal, who points out, correctly I believe, that shareholder capitalism constituted bad theory and that bad theory led to both bad managerial practices at American firms—including stock option compensation—and bad teaching at business schools, perhaps including the one where I have been teaching these past 40-odd years.

I conclude with a return to the basic notion of this book, namely, the interdependence of democracy and capitalism, and the question of how to make the US models of both safe for the world today. Suggestions for effective remedies are presented in the next, concluding, chapter. Finally, in the epilogue to this book, I offer an account of one immediate consequence of the dominance of free-market ideology: the rise of the financial sector in the United States as a new oligarchy and the onset of financial crisis. Relying on remarks made by Paul Volcker, the former Chairman of the Federal Reserve, I describe the effects of deregulation on a macroeconomic level. The "toxic trio" contributed to a weakening of the political system and a strengthening of the economic system, such that Wall Street firms today wield remarkable influence over Washington. Here I draw upon a recent account by Simon Johnson, an MIT Sloan professor and a past chief economist at the IMF, who explains that the rise of a new financial elite and the re-emergence of the laissez-faire model of capitalism that prevailed in the 19th century has been accompanied by oligarchic outcomes arguably incompatible with the democratic principles.

From Social Democracy to Libertarianism for the Business Elites

The transformation of US capitalism during the 20th century is remarkable not only in relation to US history, but also in relation to other industrial countries' experience during the time period. From the 1930s to the mid-1970s, US economic policies converged toward those of its counterparts in Canada, the United Kingdom, and Western Europe. Those counterparts were social democratic at the time, i.e., they followed policies aimed at protecting both labor and consumers from the full effects of lightly regulated competition, and notably in the markets for capital and labor. As the century progressed into the 1980s, however, both US policy and its resultant capitalist model diverged significantly from those of the continental European countries and even Canada.

Indeed, the Canadian case provides something of a natural experiment in what might have happened if the United States had resisted the siren call of deregulation for its financial markets. Since Canada did not deregulate its financial services sector, it was not much affected by the financial crisis that began in August 2007, and had no need to take radical measures to weather the storm. Canada has long been one of the top trading partners of the United States, but its capitalist system remains institutionally distinct. Its six major banks are each national in scope. Each of these banks could, in effect, have its own internal mechanisms for credit allocation across regions and risk preferences, and this internal market could be managed by the visible hands of managers, like the vertically integrated industrial firms discussed in the previous chapter. Canada's banks kept their credit risks largely within their firms, which meant that they had great incentives for careful lending, rather than selling large amounts off to markets in search of higher profits through higher leverage albeit at lower standards in security. But while trade and money flow easily across borders, capitalist systems do not, and American and Canadian capitalism became even more distinct national systems.

During the earlier half of the century, most industrial countries, the United States included, turned to what I have referred to as a "social democratic" model of capitalism. Coming out of the economic crisis of the 1930s, most, if not all, of the industrial democracies adjusted their capitalist systems to some degree, limiting the effects of the "free" market in order to achieve a sense of shared responsibility and, if need be, sacrifice. These adjustments took place several times, first during a period of extreme economic distress, during and immediately after the Depression, then during a period of military conflict during World War II, and then during several years of acute shortages as the European countries and Japan rebuilt after World War II. This social democratic model embodied policies that provided social insurance for sickness, accidents, retirement, and unemployment and created conditions for collective bargaining and a higher share of national income for labor. In addition, most, if not all, of the liberal democracies imposed unusual taxes to finance World War II and then retained those high taxes afterward in order to pay for unusual expenses, including the reduction of wartime debts.

The United States was no exception in terms of most of these bare essentials of social democratic capitalism. The nation emerged from the Great Depression and

World War II as a welfare state. The government was at least informally committed to maintaining and expanding aggregate demand as a way to support employment and wages; it was committed to creating safety nets for the poor and for senior citizens; and it was committed to recognizing the rights of labor to join a union and of unions to bargain collectively with employers. However, the United States was a clear exception among the industrial welfare states in not providing a system of universal health care.

The mid-century United States variant of social democracy accepted the Keynesian notion of the state as a stabilizer of aggregate demand through its fiscal policies, added the notions of social insurance for old age and retirement (but not universal health care), and recognized the rights of labor to bargain collectively. Accordingly, US wages were at or near the top of the world as a share of national income, and higher than almost any of the European countries and its distribution of income by deciles was broadly similar to the European. Unlike many other industrial countries, however, the United States did not have any significant share of its economy run by state-owned enterprises, nor did it have specialized training for its civil service employees. The state was a concept that was not bolstered by any special corps of civil servants that was committed to serving the public interest. Here it was and remains in sharp contrast to the United Kingdom, France, Germany, and Japan, among others.

The US version of social democratic capitalism carried considerable bipartisan support well into the 1960s. Most notably, policies protecting weaker or minority interests that began in the 1930s continued to expand. Murray Weidenbaum, an expert on trends in US regulation, points out that the New Deal reforms of the 1930s were notable for regulating the economic activities of firms, such as through the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Federal Communications Commission, and the Civil Aeronautics Board.[3] Later in the 1960s and 1970s, such regulation expanded rapidly to include not only firms but also larger social phenomena such as environmental protection, consumer product safety, occupational safety and health, and equal employment opportunity.[4] And since the new regulations were backed by authorities in Washington, i.e., the federal government, they were safe from the race to the bottom that had largely eviscerated earlier attempts at providing such social benefits during the late 19th century, when state governments had haphazardly and vainly initiated regulatory controls.

This picture of increased and indeed strong economic and social regulation changed as the 1970s drew to a close under the presidency of Jimmy Carter.[5] Several

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[3]Murray Weidenbaum, *Business and Government in the Global Marketplace*, ed. P.J. Boardman, Rod Banister, and Gladys Soto, 7th ed. (Prentice Hall, 2003), 29.

[4]Ibid.

[5]For a good comparison of regulatory regimes among industrial countries, see Hall and Soskice, ed., *Varieties of Capitalism*. They classified the United States in the 1990s as among the Liberal Market Economies (LMEs) along with Australia Britain, Canada, and New Zealand, and I would do the same. They also show how their coordinated market economies (CMEs) on the continent did more steering of their respective economies through their labor markets.

trends clearly indicate substantial change to the US economic model during this time.

First, consider changes to income distribution, both in the United States and elsewhere. The US distribution of incomes, at least at the high end, has experienced four distinct periods in the years since systematic data became available, as shown in Fig. 14.1. These data show a relatively stable share of about 45% of incomes for the top 10% of taxpayers in the United States from 1913 (when the data series begins) until 1941, followed by a very sharp drop to around 32–33% by 1944. The latter distribution continued into the early 1980s, at which point it began to increase again, to approximately 42% in 1998, a level much like that before World War II.

Each change in the income distribution roughly indicates a corresponding change in the US capitalist model. During the first period, from 1916 until the late 1930s, the top 10% of the income earners enjoyed about 45% of reported incomes, thanks in no small measure to the laissez-faire model, as discussed in Chap. 13. World War II caused an abrupt change in economic policy during 1940–1945 that was at least partially continued until 1980, with social democratic capitalism resulting in a more even distribution of incomes throughout the presidencies of Eisenhower, Kennedy, Johnson, Nixon, Ford, and Carter. As the Reagan Administration ushered in a return to laissez-faire and greater economic inequality, labor protections

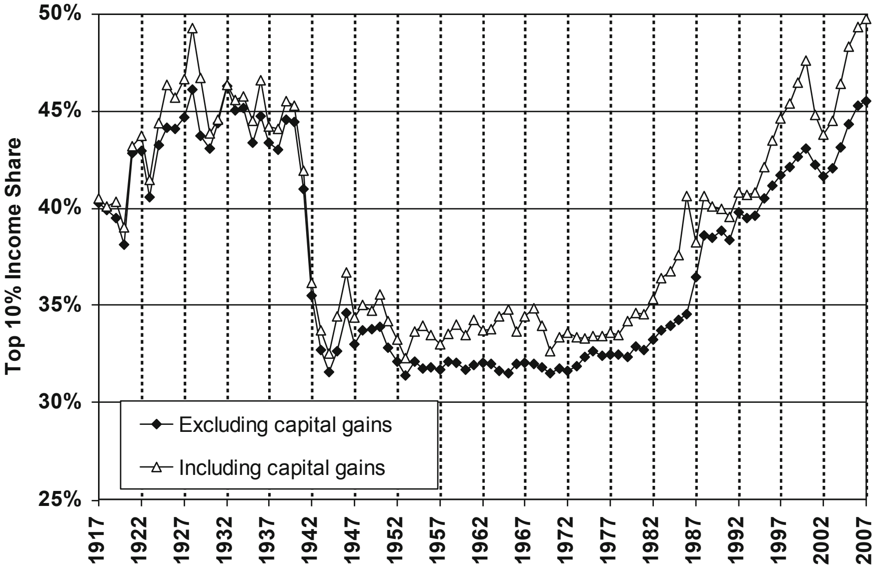

Fig. 14.1 The top deciles' share in US incomes, 1917–2007. Top decile includes all families with annual income above $109,630 in 2007. Note: Income is defined as market income (and excludes government transfers). Source: Emmanuel Saez and Thomas Piketty, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics*, 118(1), 2003: 1–39, Figure 1. Updated figures accessed through Emmanuel Saez's MIT homepage [http://elsa.berkeley.edu/~saez/]

and antitrust enforcement all but disappeared and financial regulation was relaxed. These data bear further significance when compared to the same time period for other industrial countries, especially those in Western Europe, of which France is a good illustration. As shown in Fig. 14.2, France had a broadly similar distribution of incomes to the United States prior to 1935 and experienced a similarly sharp drop in inequality between 1935 and 1945, as both countries experienced changes to economic policy during the unusual circumstances of World War II. And both countries broadly maintained their social democratic priorities during the so-called "Golden Years" of high growth, circa 1948–1973, though France experienced a brief period of rising inequality relative to the United States during the 1960s. But after 1980, the data suggest a divergence; where the income distribution in France (and in most other continental European countries) remained stable, that in the United States became steadily and sharply more unequal, so that by the late 1990s it had returned to the levels experienced in the 1920s.

The unique path taken by the United States, relative to most of Europe, can also be seen quite clearly at the level of individual incomes after 1980. Whereas US GDP per capita continued to rise throughout the last quarter of the 20th century, median incomes for male workers stagnated. The explanation was to be found in the increasing number of women in the labor force, the longer hours worked, and the extraordinary increases in pay within the top 10% of the labor force. Indeed, Americans worked a much longer workweek than their European counterparts, and about 50% longer than the Dutch, who were near the other extreme. To some extent,

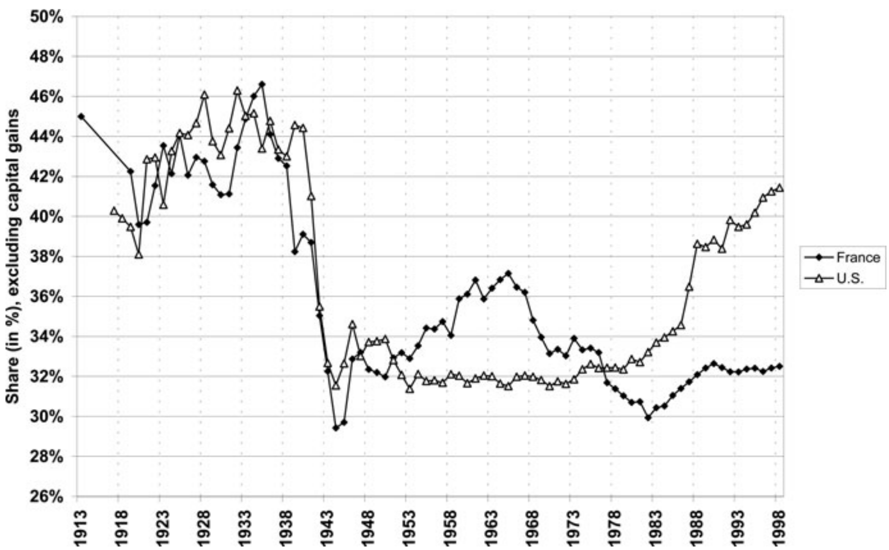

Fig. 14.2 Income distribution: The top decile income share in France and the United States, 1913–1998. Source: Thomas Piketty and Emmanuel Saez, *Income Inequality in the United States, 1913–1998*, NBER Working Paper No. 8467 (Cambridge: National Bureau of Economic Research, 2001)

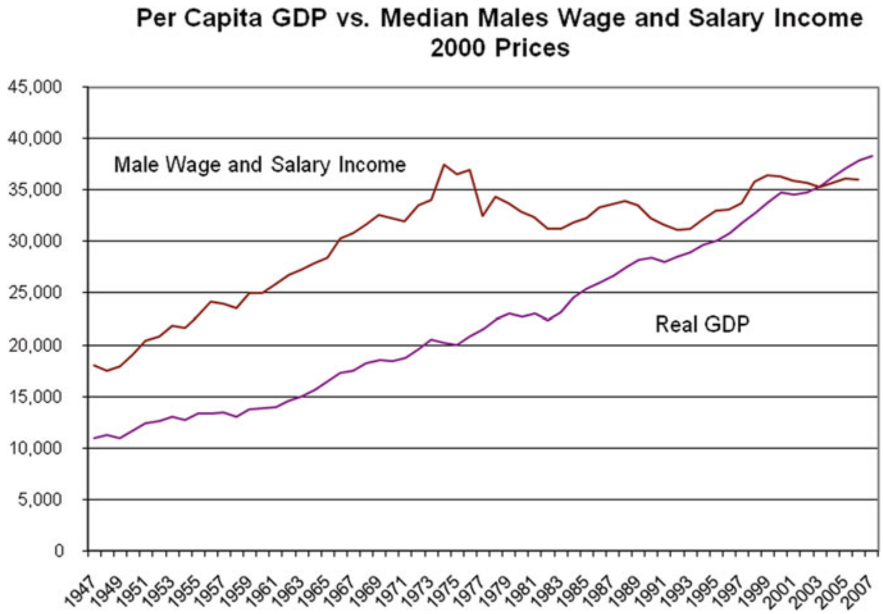

Fig. 14.3 GDP per capita versus worker pay per worker. Source: US Department of Commerce; US Census Bureau

these US data were evidence of increased opportunity, for example, much greater career choice for women, but, at the same time, they were evidence that it took two incomes to maintain an American standard of living for a growing proportion of the population. (Interestingly, this standard was one characterized not only by lower real incomes but also by decreasing savings, increasing consumption, and thus increasing debt, as we will see when we come to the macroeconomic exhibits in the Epilogue.) (See Fig. 14.3.)

If we shift our focus from the median male to the average CEO, the United States again appears to be an anomaly. Figure 14.4 shows CEO pay levels in the United States and in several other leading industrial countries in 1999; although today the data are a bit outdated, they indicate a pattern that has if anything grown more extreme. In 1999, with average CEO pay for large manufacturing firms at 475 times that of the average employee in the same firms, US CEOs were simply in a class unto themselves. Formal pay figures may not be strictly comparable across countries, as the norms in some countries may make provision for fringe benefits paid by the firms but not credited directly to the pay of senior executives (e.g., access to a free car, perhaps with a driver, trips on a company plane, and expense accounts that allow for extraordinarily expensive wines). Nevertheless, the evidence suggests that the US model of capitalism permitted great concentration of wealth for its top executives, mirroring the data on general wealth concentration, shown above in Fig. 14.2.

Why did the US microeconomy diverge so strongly from the social democratic model of capitalism that it had followed for almost 50 years? With most other

Fig. 14.4 US CEO compensation leads all others. Note: Includes incentive packages composed of shares and share options. Source: Towers Perrin; Standard & Poors, as reported in "Executive Pay," *The Economist*, September 28, 2000

countries, particularly those in Europe, remaining committed to the social democratic model, the answer must logically lie with events and decisions particular to the United States itself. Perhaps unexpectedly, these defining decisions began well before the 1980s, and in social and political institutions rather than economic ones. The uniformity across these three realms, in my view, is that the United States deregulated or broke down the structures of its various systems, social, political, and economic. While some of the changes seem to have been simultaneous, overall, the economic was the last of these three major systems to be deregulated.

The Return to Laissez-Faire

As stated in the introduction to this chapter, it is my hypothesis that the late 20th century transformation of US capitalism, from a social democratic model to a laissez-faire model, is broadly attributable to the deregulation, and attendant disintegration of order in almost all of its various societal, political, and economic structures and systems. In all of these areas, the early pressures to attack prevailing or traditional structures came from largely exogenous instabilities which began in the 1960s. While I often connect the ideas of Milton Friedman with the notion of deregulation, his theory was not the immediate stimulus of the transformation. In fact, Friedman's book, when published on the eve of these events, was barely noticed, as he himself explained later.[6] However, by the 1980s, Friedman was a rock star, so to speak, and his notion of free, deregulated markets was a key source of that fame.

[6] As this happened, the writings of Milton Friedman became much more popular. As he writes in the preface to the second edition to his famous book, it was initially a near-failure: "[W]hen this book was first published, its views were so far out of the mainstream that it was not reviewed by any major national publication." See Milton Friedman, "Preface," in *Capitalism and Freedom*, 40th Anniversary Edition (Chicago: University of Chicago Press, 1962, 1982), vi.

The ideas of deregulation and free markets began to transform US capitalism and democracy as early as the late 1960s, in response to some objective, real-world events such as wartime inflation followed by more of the same due to rising commodity prices such as oil. While many and perhaps most of these events are familiar to Americans of a certain age, it was easy to overlook just how profound and widespread the underlying causes of deregulation turned out to be. Starting in the 1960s, the United States experienced rapidly rising instability in all of its major systems. Most readers will recall the instability of the economic system; the economy was affected by inflation that rose sharply after 1965, as I will explain further below. But at least as important were the instabilities in the social and then political systems. The US social system was greatly affected by civil disobedience protesting institutionalized racism, initially in the south where racism was entrenched as segregation, and notably in public accommodations, public education, and public employment. These protests gradually broadened to affect private institutions as well, and they gradually moved north where segregation was less rigidly established or enforced. Several years of civil protest and even disobedience led to violence such as sit-in demonstrations in violation of local regulations that was eventually followed by landmark Civil Rights legislation in 1964–1965. Political disorder followed almost immediately from nationwide protests against the Vietnam War, but also building on the already-brewing social instability.

The violence created a deep sense of instability. As a parent I watched with my three children as television images of Civil Rights marchers being beaten with rubber hoses and attacked by dogs, student protests on campuses directed against US involvement in Vietnam, and then counter-demonstrations. In one striking incident, national guardsmen opened fire on student demonstrators at Kent State in Ohio, killing four unarmed students on campus. Even at the time it seemed clear to me that the sources of instability were intertwined between the social and political systems. The economic instability was relatively mild until the period 1969–1970, after which it became much more apparent through at least the early 1980s.

Deregulation of Social Structures

The story of the Book-of-the-Month Club, related by Fareed Zakaria in *The Future of Freedom* in a powerful chapter on "The Death of Authority," provides a miniature illustration of the deregulation of social structures in America during the 1960s and early 1970s, as well as the dramatic disruption of social order that ensued. As Zakaria tells it, the Book-of-the-Month Club was founded in the late 1920s as a means to "expose the newly educated American middle class to the joys of great literature."[7] A five-person panel of respected writers, drawn from academia, publishing, and journalism, selected "high-quality literature that could appeal to a broad

[7] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 215.

audience."[8] Yet in the 1960s, popular sentiment rose against the Club, such that the "experts" were seen as overbearing "elites," unjustly imposing their ideas upon the American public. The Book-of-the-Month Club would never be the same. As Zakaria notes, after the Club was purchased by Time Inc. in 1977, "the judges' autonomy was completely eroded and the club's selections . . . became those books likely to succeed commercially . . . It was a complete inversion of the original idea. Instead of trying to shape popular taste, the BOMC was trying to mirror it."[9] The free market of consumers, however uneducated or unguided, was to be the ultimate arbiter of quality.[10]

What happened to the Book-of-the-Month Club exemplifies contemporaneous shifts in American society. Popularity replaced any notion of "taste, standards, and hierarchy."[11] One explanation for this change, as Zakaria notes, was that popularity "translates into profit. This cultural trend illuminates something important: the relationship between democratization and marketization."[12] The freer a particular market, the more democratic and therefore desirable it was, regardless of the equilibrium level those market forces led to; if the public wanted to read a manual on "How to Get Rich Quick" instead of classics by Jane Austen or Henry James, that was its democratic prerogative.

But why did this all occur in the 1960s? Put simply, the decade was a remarkable period of societal turmoil and instability among Americans, particularly with respect to the Civil Rights Movement and the Vietnam War. Tensions surrounding both issues led the public to rise against any and all notions of "authority" or "standards," which were indiscriminately seen as limiting, unjust, and undemocratic and, in the case of racial segregation, immoral as well. In an era of increasing awareness of civil injustices, and notably legalized segregation of African Americans, deregulation and democratization promised increasing inclusion of those who had previously been excluded. Re-evaluating the role of cultural arbiter occupied by entities like the Book-of-the-Month Club, one might then ask how many of the judges were white, or even white males at that? The same questions could certainly be asked of leading accounting firms, law firms, and investment banks, as well as various professional associations. Standards in America had long been established by elite organizations that just happened to be dominated by White Anglo-Saxon Protestants ("WASPs"), and men. Accordingly, as tensions over civil rights escalated, so did attacks on organizations apparently led by this homogenous demographic and the standards that they espoused, regardless of the independent value of those standards. Thus, the beginnings of change in the social realm came not from classroom seminars,

[8] Ibid.

[9] Ibid., 216–217.

[10] For a thorough account of the Club, see Janice A. Radway, *A Feeling for Books: The Book-of-the-Month Club, Literary Taste, and Middle-Class Desire* (Chapel Hill, NC: The University of North Carolina Press, 1999).

[11] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 217.

[12] Ibid., 219.

but from bottom-up mobilization of public sentiment against “elite” groups and their unjust, uncivil, and undemocratic norms. Street demonstrations and, more broadly, societal instability characterized the decade. Two examples will illustrate what happened, one drawn from race relations and the other from education.

Liberalizing Race Relations

Race relations were dramatically reformed during the 1960s, as the Civil Rights movement picked up speed with the support of students, prominent black leaders, and leading politicians such as President Lyndon Johnson. The social sphere was deregulated, notably by policies of desegregation that were structured to improve the way blacks were regarded and treated across the country. To achieve such dramatic change, desegregation inevitably involved disruptions to traditional standards (e.g., in hiring practices) and to community structures (e.g., exclusionary zoning). I will discuss each of these side effects of social instability in turn.

Demonstrations against racial segregation in the United States began on a very small scale in the south in the 1950s. By the mid-1960s, the demonstrations had become widespread, larger in scale, and much more highly publicized, thanks chiefly to television. The assassination of President Kennedy in 1963 added strength and passion to the Civil Rights Movement, and the Johnson Administration seized the opportunity to embark on a bold program of social reform aimed at implementing proposals that had been languishing in Congress prior to the assassination. Johnson, the master tactician, was able to secure passage of two key pillars of reform that had eluded his predecessor, namely, the Civil Rights Act of 1964 and the Voting Rights Act of 1965. Together, these two acts paved the way for increased public spending and an increased role for the federal government in promoting desegregation in the south.

One of President Johnson’s key reforms, accomplished without explicit Congressional authorization, was to change the basic goal of the Civil Rights reforms from achieving “equality of opportunities” to the more ambitious “equality of outcomes.”[13] This change would have profound effects, somewhat following the pattern of the Book-of-the-Month “deregulation” discussed above. Old standards were overthrown in order to promote racial equality and thereby accelerate the integration of blacks into mainstream institutions from which they had previously been barred. Numbers at times took precedence over the notion of negotiating gradual changes through political processes. Numerical outcomes became the accepted best way to judge the achievement of equality of opportunities in any given setting; they were thought to be simple, objective, and incontrovertible. The end justified the means, and in this case quotas were often the means of achieving change in a school’s population or an organization’s workforce. Of course, unlike in the case of

[13] See Charles Murray, *Losing Ground: American Social Policy, 1950–1980* (New York: Basic Books, 1984).

the Book-of-the-Month Club, where deregulation undermined literary standards that were of arguable merit, the deregulation of social relations led to the removal of barriers to access, some of which were unquestionably racist, and in any event without independent value. These changes were often accompanied by the rapid promotion of persons with only modest qualifications, which invited bitterness, protest, and sometimes violence.

Affirmative action implied that the ends (equality of outcomes) must be prioritized, but at the same time it suggested that previous standards had been either explicitly or implicitly racist. What then were the new standards? And by what means were they to be established? Affirmative action ranked standards as a secondary consideration; the priority was rapid change in the allocation of jobs or school acceptances. If one insisted on rapid change in racial or other representation, what selection criteria were to be used? How were grading standards to be maintained? What study materials were to be used? What happened if not enough minority students received satisfactory grades? Should there be quotas so as to achieve the mandated results? How rapidly were the numerical goals to be achieved? Obviously, there were no hard and fast answers, but pressures for rapid change tended to reduce the attention to the means that were chosen. Discussion of these events was still contentious when an official review was undertaken in the early 1980s, in an official report called *A Nation at Risk*, as discussed below.

A second and quite unexpected result of desegregation came through its impact upon the so-called "ghetto" communities of the country. While these ghettos have existed throughout the 20th century, they earned their negative reputation of crime, out-of-wedlock births, and extreme poverty from the 1970s onward, and paradoxically even more so *after* desegregation took effect. If blacks failed to qualify in the appropriate numbers once the official barriers were taken down, what did this mean and what was to be done? William Julius Wilson, a professor of American Sociology at the University of Chicago and later at Harvard, posed the conundrum well: "If contemporary discrimination is the main culprit [as many propose], why did it produce the most severe problems of urban social dislocation during the 1970s, a decade that followed an unprecedented period of civil rights legislation and ushered in the affirmative action problems?"[14] The story, according to Wilson and other scholars, including Nicholas Lemann, who spent considerable time on the ground studying the ghettos of Chicago before writing two remarkable articles in *The Atlantic Monthly*, is that desegregation during the 1960s facilitated a dramatic restructuring of the demographics of these predominantly black communities.

As blacks migrated north in significant numbers during the early 20th century, segregation remained a remarkable reality in the major cities. As a result, racially homogenous but socioeconomically diverse communities sprang up in isolated sections of these cities. Lemann, writing about Chicago in particular, explained the structure of these communities: "... because the segregation was by race, the

[14] William Julius Wilson, *The Truly Disadvantaged: The Inner City, the Underclass, and Public Policy* (Chicago: University of Chicago Press, 1987), 30.

ghetto was fairly well integrated by class. It was a community, with leaders and institutions—poor, with unusual difficulties, but a community nonetheless. From the First World War through the mid-sixties the black leadership regarded the high crime and low marriage rates of the black lower class as problems it had to solve, sometimes with a sigh . . . It would, in sociologists' language, help the lower class to acculturate."[15] Wilson echoes this narrative: ". . . in the 1940s, and 1950s, and even into the 1960s, these neighborhoods featured a vertical integration of different income groups as lower-, working-, and middle-class professional black families all resided more or less in the same ghetto neighborhoods . . . the very presence of working- and middle-class families enhanced the social organization of inner-city neighborhoods."[16]

When desegregation took effect in the 1960s, the economic and social barriers forcing blacks to remain in these communities tumbled down, and the black professional, middle, and working classes moved, more or less en masse, out of the ghettos and into communities with greater socioeconomic opportunities. All of a sudden, the demographic of the ghettos was disproportionately concentrated around the least educated, least privileged of the urban black community, and the role models previously supporting their self-improvement disappeared.[17] Without this supporting network, which Wilson terms a "social buffer," those left behind were subject to the full impact of the recessions of the 1970s and 1980s. As he explains: ". . . even if the truly disadvantaged segments of an inner-city area experience[d] a significant increase in long-term spells of joblessness, the basic institutions in that area (churches, schools, stores, recreational facilities, etc.) would remain viable if much of the base of their support comes from the more economically stable and secure families. Moreover, the very presence of these families during such periods provide[d] mainstream role models that help keep alive the perception that education is meaningful, that steady employment is a viable alternative to welfare, and that family stability is the norm, not the exception."[18] But, as mentioned above, these families and their norms left in the exodus of the 1960s, spurred by the sudden increase in opportunities due to formal desegregation. Without their presence, the ghetto community was left both economically and socially impoverished, as well as increasingly isolated from the rest of American society.

Subsequently, the ghetto developed a new culture based around a new set of role models, including especially the young, black, and single males. As Lemann explains, "A fundamental reason that so many unmarried teenagers have children in the ghetto today seems to be that having them has become a custom—a way of life. The story I heard over and over from teenage mothers was that their pregnancies were not accidental. Their friends were all having babies. Their boyfriends had

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[15]Nicholas Lemann, "The Origins of the Underclass: Part II," *The Atlantic Monthly*, July 1986, http://www.theatlantic.com/politics/poverty/origin2.htm. Used by permission of the author.

[16]Wilson, *The Truly Disadvantaged: The Inner City, the Underclass, and Public Policy*, 49.

[17]Ibid., 58.

[18]Ibid., 56.

pressured them into it, because being a father—the fact of it, not the responsibility—is a status symbol for a boy in the ghetto."[19] This new standard of illegitimacy was part of a "separate, self-sustaining culture" that became increasingly isolated from the rest of society, black or white, both externally, by individuals leaving or avoiding it, and, internally, by individuals within it rejecting outside, bourgeois norms as forcing them to "act white."[20]

Thus, while undoubtedly beneficial to the black community and to US society on the whole, the liberalization of race relations, via legally mandated desegregation, also led indirectly to demographic disorder, shaking up the social structure and standards of US society at large and the ghetto community in particular. Segregation was a dysfunctional as well as immoral form of social structure; it was replaced by increased freedom, less structure, and much less order and increased isolation. This increased isolation of ghetto communities remains in many northern cities 50 years later, maintained in part through discrimination in lending as well as public services such as law enforcement. Despite its obvious new opportunities for African Americans, desegregation can also be seen to have had a negative impact on surrounding areas and indeed society as a whole because it has been difficult to build consensus on a societal model of governance in the desegregated context. While it no doubt offered important gains, freedom also invited disorder, and disorder was not necessarily conducive to improved performance, not least in urban schools.

Liberalizing Education

It goes without saying that educational standards, institutions, and opportunities in the ghetto declined dramatically after the 1960s, as role models of family stability and professional aspirations disappeared from the community. Keeping order in the schools was made more challenging by the decline of order in the streets. But less discussed has been a similar decline at the top levels of public education, taking place during the same period. Just as traditional standards were uprooted in the realm of race relations, they were questioned in the realm of education, with profound effects.

Where did this more general instability, beyond racial desegregation, come from? The answer again lies in the policies of Johnson and the public's powerful and unpredictable reaction to them. The commitment to simultaneously pursue expanded social programs at home and an expanded war effort abroad created a budgetary bind for Johnson, adding to wage pressures, inflation, and general economic instability for the country. Social instability increased, adding violent, antiwar protests across the country to the (mostly peaceful) civil disobedience already going on to promote Civil Rights in the south. These two causes eventually evolved into

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[19]Nicholas Lemann, "The Origins of the Underclass: Part II," *The Atlantic Monthly*, July 1986, http://www.theatlantic.com/politics/poverty/origin2.htm.

[20]Ibid.

protests on college campuses as well as rioting and the setting of fires in some of the largest cities. By 1968, polarization over racial relations and the Vietnam War brought conflict and violence to many college campuses, the forced resignations of a number of university presidents, and curriculum battles from graduate schools clear down into middle schools. In the end, much of the US educational system chose to resolve the tension through a process of "deregulation" or free choice. Curricula were liberalized, student choice maximized, graduation requirements watered down, and the passage from one grade to another facilitated in order to bypass discredited standards.

The consequences of these events for the US educational system were summarized and evaluated in the early 1980s, by a blue ribbon panel to the Secretary of Education entitled *A Nation at Risk*.[21] Among its principal findings were the following:

> Secondary school curricula have been homogenized, diluted and diffused to the point that they no longer have a central purpose. In effect we have a cafeteria style curriculum in which the appetizers and desserts can easily be mistaken for the main courses. ... The proportion of students taking a general program of study has increased from 12% in 1964 to 42% in 1979 ... Twenty five percent of the credits earned by the general track high school students are in physical education work experience outside the school, remedial English and mathematics, and personal service development courses, such as training for adulthood and marriage. The amount of homework for high school seniors has decreased (two thirds report less than one hour a night) and grades have risen as average school achievement has been declining. The time spent (on biology, chemistry, physics, and geography ... based on class hours, is about three times that spent by even the most science-oriented U.S. students, i.e., those who select four years of science and mathematics.[22]

What the report said, in broad terms, was that the structure, standards, and discipline in America's public schools had been allowed to decline, and its recommendations, in substance, were that structure, standards, and discipline should be restored. What the report did not say, or even hint at, was when the changes had been made, why, or by whom. Even in 1983, the subject matter was still too contentious and the sides too polarized to permit a public report to be issued summarizing what had happened, let alone why. The subsequent record shows that the performance of the US school system stopped improving in 1970 and that, from then on, the United States fell steadily in terms of academic achievement in its public schools compared to many other countries. The decline in standards and in student performance was all in the name of bringing liberalization, new electives, and more student choice. At the same time, it masked some very real problems, i.e., that it was too difficult to have frank discussions of the social tensions of the time. Free choice, however poor the results of such choice, challenged any form of standards in the educational system.

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[21] The National Commission on Excellence in Education, *A Nation at Risk: The Imperative for Educational Reform; A Report to the Nation and the Secretary of Education* (United States Department of Education, April 1983).

[22] Ibid.

While *A Nation at Risk* avoided the "why" behind the decline of the US educational system, Daniel J. Singal, a professor of history at Hobart and William Smith Colleges, gave a clear and in-depth analysis of this "why" for a part of the US population in his article "The Other Crisis in American Education," published in *The Atlantic Monthly* in 1991. He noted the same decline in the performance of the college-bound student population that the earlier report did for the population as a whole; for instance, he highlighted how the number of high school seniors taking the SAT who achieved a verbal score over 600 declined by nearly 40% between 1972 and 1983 and remained low into the 1990s. His explanation for this decline pointed to the cultural ferment of the 1960s, described as follows:

> In every conceivable fashion the reigning ethos of those times was hostile to excellence in education. Individual achievement fell under intense suspicion, as did attempts to maintain standards. Discriminating among students on the basis of ability or performance was branded "elitist." Educational gurus of the day called for essentially nonacademic schools, whose main purpose would be to build habits of social cooperation and equality rather than to train the mind. A good education, it was said, maximized the child's innate spontaneity, creativity, and affection for others. To the extent that logic and acquired knowledge interfered with that process, they were devalued. This populist tidal wave receded by the late 1970s, but the mediocrity it left in its wake remains.[23]

What Singal was describing was, in short, the liberalization or deregulation of the educational system from the 1960s onwards. Traditional standards were replaced by more democratic and equalizing "non-standards." To wit, formal drills were replaced by personal expression, emphasizing feeling over fact; year-long courses in English, History, and Social Studies were replaced by shorter-term electives on politically correct social issues; and the pedagogical objective of "stretching" students to achieve their highest potential was replaced by that of avoiding any "stressing" of students, evidenced by a drastic reduction in the amount and length of assignments. Yet, as Singal points out, those few schools that bucked the trend of declining student performance were those that held onto the old standards, sharing three main qualities: (1) "the belief that academics must invariably receive priority over every other activity"; (2) "a dogged reliance on a traditional liberal-arts curriculum"; and (3) "the practice of grouping students by ability in as many subjects as possible."[24]

The rejection of this last traditional standard perhaps yielded the most dramatic effects, as schools were "adjusted" to the benefit of the low achievers and to the detriment of the high achievers. Singal explained: "Perhaps most crucial, the sixties mentality, with its strong animus against what it defines as 'elitism,' has shifted the locus of concern in American education from high to low achievers . . . The prevailing ideology holds that it is much better to give up the prospect of excellence than to take the chance of injuring any student's self-esteem . . . one often senses a virtual prejudice against bright students. There is at times an underlying feeling, never

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[23]Daniel J. Singal, "The Other Crisis in American Education," *The Atlantic Monthly* (November 1991), http://www.theatlantic.com/politics/educatio/singalf.htm.
[24]Ibid.

articulated, that such children start off with too many advantages, and that it would be just as well to hold them back until their less fortunate contemporaries catch up with them."[25] It was a drastic liberalization of education, aiming for equality over excellence and mimicking in many ways the racial deregulation noted above. The goal was "to lift up those on the bottom, whether they were there because of race, class, ethnicity, or low ability."[26] But in the process, those at the middle and top were neglected and effectively brought down far below their potential level of achievement.

Herein lies the great "why" behind the overall lowering of educational performance across the nation: democratization. The instability of the 1960s made liberalization or democratization—taking the form of increased individual "freedom" through deregulation—the prevailing policy in not only the social but also the political and economic realms, as we will see. In terms of the educational system, liberalization was meant to free students from the so-called constraints of traditional educational standards. Students were freed from "elitist" conceptions of what material they should read, how they should engage with it, and where their studies should lie among their ever-important individual priorities. And the lowest achievers were additionally freed from pressure to keep up with the pace of the "elites" among their peers, i.e., the higher achievers. Liberalization essentially placed the individual student's priorities over those of any pre-set pedagogy, and then placed the potential of the lower achievers over that of the higher achievers. The markets of education were arguably more "free," but the equilibrium to which they led was one where an apparent equality prevailed over aspirations and opportunities for excellence. It was an equilibrium characterized by mediocrity, boding badly for the future of the country both domestically and internationally.

The Market-Based Solution

My objective in this section has been to describe the effects of liberalization, democratization, and deregulation on the US social sphere during the mid- to late-20th century; I have not attempted to go into the much more complex and nuanced territory of recommendations for reform. But, allow me to cite one example of what spontaneous, market-based adjustment might look like. As noted above, broadly speaking, US public schools stopped improving in the 1960s. However, rising average incomes and stagnant performance in public schools opened the way for differentiation by school district, whereby a district with good schools could expect to have additional demand for places within its system, with this increase in demand then reflected in rising relative housing prices. Houses located in good school districts were thus worth more than similar houses in poor school districts. This created a vicious circle: Rising housing prices generated higher local tax revenues to finance

[25] Ibid.
[26] Ibid.

better schools. Schools with more income per pupil could hire better teachers and then improve again in their relative performance. Since tax revenues per pupil within a big city and its suburbs could easily have differentials of five or even six times, this meant that there was a geographically based market for public education. And, in effect, the market for public education became a new vehicle for the promotion of segregation, by income more than by race. As time passed, good school districts came ever closer to being highly selective, if not private, at least in terms of the cost of the ticket of admission. One form of segregation was being replaced by another, with potentially very long-lasting implications.

As the narrative of this chapter continues through the political and economic realms, we will see this pattern again and again: discontent with traditional systems and standards led to instability and calls for reform; these calls were answered with policies characterized by deregulation; these policies shake up the status quo, market-based experiments are tried and eventually, a new system emerges, nominally based on "free market" principles, but effectively based on the single standard of ability to pay. The following account of political deregulation in the United States during the late 20th century tells much the same story but in a very different sector of society.

Deregulation of Political Institutions

The transformation of American democracy, beginning in the 1960s, is discussed in detail by Zakaria in a remarkable chapter of *The Future of Freedom* that he aptly entitles "Too Much of a Good Thing." He begins his analysis with the instability of the 1960s and the challenge it posed to the legitimacy of US democracy. In his words, "Most Americans barely remember how broken their country seemed in the early 1970s. Battered by the humiliation of Vietnam it was struggling with stagflation, oil crises, race riots, and rising crime."[27] He notes that they also forget that only a few years earlier, Americans showed a strong sense of civic engagement by regularly participating in elections. In the 1960s, up to 70% of Americans had told pollsters that they expected their government to do the right thing most of the time.[28] Since then, satisfaction with government and voter participation in presidential elections have both dropped from 70% to about 30% and from about 60% to 40%, respectively.[29] Zakaria finds that even politicians themselves have become increasingly critical of US democracy, with long-time Speaker of the House of Representatives, Thomas (Tip) O'Neill, commenting that although the quality of Congressmen has improved, the "results are definitely worse," and presidential

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[27] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 161.

[28] Ibid., 162–163.

[29] Ibid., 162–163. Zakaria gives no specific end date for the listed percentages; 30% and 40% are thus assumed to refer to the time of the publication of his work (2003, 2004).

candidate Ross Perot similarly describing Washington as "Good people, bad system."[30] Zakaria summarized these and other trends as indicating that "Simply put, most Americans have lost faith in their democracy."[31] What a strange attitude for a public whose country had opened up its politics to public scrutiny and participation, greatly improved its race relations, won the Cold War, and enjoyed continued economic growth. Why did Americans, from the late 1960s on, lose faith in their political system and, to this day, never regain it?

According to Zakaria, the answer lies in "the democratization of politics ... Since the 1960s most aspects of American politics—political parties, legislatures, administrative agencies, and even courts—have opened themselves to greater public contact and influence in a conscious effort to become more democratic in structure and spirit. And curiously, more than any other, this change seems to coincide with the decline in standing of these very institutions."[32]

The trends that Zakaria calls democratization of the political system are, as I see it, trends of deregulation. Since 1968, US democracy has experienced a very substantial transformation in its two principal sets of "political markets": the markets for selecting candidates for office (e.g., primaries and general elections) and the markets for crafting and securing passage of legislation (congressional committees and legislative voting procedures. Zakaria conceptualizes the key changes as "increased opening" and "democratization," explaining that "America is increasingly embracing a simple minded populism that values popularity [votes] and openness as the key measures of legitimacy."[33] The role of regulatory authority, or human agency, was increasingly replaced by the invisible hand of political market forces, i.e., direct votes by the citizenry, acting much like supply and demand or a pricing mechanism. The political system was to be as impersonal, objective, and transparent as possible. A similar claim could be made regarding the judicial system, based on the increase in frequency and scope of judicial elections, a peculiarly American phenomenon that raises significant questions of judicial independence.

In the course of his analysis, Zakaria spells out the four most critical changes to the political system: opening the markets for nominating candidates to any and all comers, with selection based increasingly on primary elections; opening legislative processes to greater public scrutiny by requiring that committee and subcommittee meetings be open to the public, where the media, lobbyists, and C-SPAN television cameras can be present as though they were agents of the voters; democratizing these same legislative processes through an increased decentralization of power to subcommittees and members; and reviving the initiative petition as a form of direct democracy. I will add a fifth change: the protection of campaign contributions as if they were expressions of "political speech," based upon a 1976 Supreme Court

[30] Ibid., 165–166.

[31] Ibid., 162.

[32] Ibid., 166.

[33] Ibid., 162.

decision in *Buckley vs. Valeo*[34] that declared political contributions to be protected by the Constitution as political speech and therefore subject to only very limited regulation.

These five changes came about thanks to the instability of the 1960s that I have described in the preceding sections, causing the very legitimacy of the US political system to come into question. It needed fixing, and the remedy was increased democratization or deregulation.[35] Starting in the 1960s, the United States "opened" key aspects of its political system in ways that were intended to make it more inclusive as well as more transparent and thus more democratic. But, as effected through the five changes noted above, this process of opening and democratizing also made US political markets more vulnerable to those with access to money and the communication powers of the mass media, especially television, and thus risked making it less democratic. In reality, the efforts to democratize or deregulate US politics shifted power away from recognized, if oftentimes unelected, party leaders toward unrecognized and unelected people whose power is derived from wealth and powerful special interests. Thus, in trying to make the political processes more responsive to the electorate, reformers unintentionally made them less so. Or, to put the matter in Abraham Lincoln's terms, in trying to make its governance more *by* the people it has become much more subject to manipulation by those with power and thus less *for* the people.

What went wrong? Zakaria's answer is that opening the US political system made it *appear* more responsive and *superficially* more democratic, while specific institutional changes made the whole process *in practice* more subject to the pressures of organized interest groups and money.[36] Why would "opening" and "democratizing" political processes make them more susceptible to political pandering and corruption? Let us examine the five reforms above, grouped into three parts (1 and 5, 2 and 3, and 4), in turn.

Primaries and Campaign Contributions (First and Fifth)

Our answer begins with an analysis of US party politics. Large-scale democracy requires organizations called parties in order to mobilize voters. Over time, a party can create a brand image with certain principles that are known to voters. It can then allow its chosen candidates to use this established brand image to win recognition in an election campaign. For some decades prior to 1968, the process of choosing this

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[34] *Buckley v. Valeo*, 424 U.S. 1 (1976). More recent cases touching on the underlying issue include *Federal Election Commission v. Wisconsin Right to Life, Inc.*, 551 U.S. 449 (2007) and *Davis v. Federal Election Commission*, 554 U.S. (2008).

[35] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 170.

[36] Zakaria's analysis was written before the impact of the Internet on fundraising had become so significant. This part of the argument might need some adjustment for the kind of fundraising that now seems to be going on in amounts so small that the contributors cannot realistically expect any tangible payback. Small contributions would seem to be true donations.

brand image or campaign platform was a function that was strongly influenced—if not controlled—by a small group of party elders. They had the power to filter out ideas and candidates who were not sufficiently aligned with the brand image they wanted to project to voters. This power paralleled, though was certainly not as strong as, that of the management of a firm to control the use of its franchise or brand; the leaders in both cases strongly influenced their respective brands or messages by admittedly undemocratic means. Another broad parallel can be drawn to the processes followed by the world's parliamentary systems, in which a select group of elected insiders wields the power to restrict the range of people considered for nomination as well as limit the range of views represented. While in the case of parliamentary systems the insiders are typically elected and therefore legitimate spokespersons for their parties, the party elders nonetheless have the capacity to restrict voter choice among candidates, namely, to restrict those choices to candidates who agree with those same elders. Accordingly, candidates in both the United States and in the parliamentary systems were likely to be selected on the basis of their prospects to fit the party's chosen political brand image and hopefully to win a general election.

Traditionally, both major parties in the United States picked their candidates, state as well as federal, at party conventions where party officials controlled a strong block of votes. Furthermore, in the national conventions to select candidates for the presidency, up through and including 1968, party leaders controlled a majority of the delegates in both of the major parties.[37] Given this context, both parties conducted their conventions through processes that were routinely characterized as dominated by "paunchy white men smoking cigars in back rooms." In 1960, only 16 state Democratic parties and 15 Republican state parties held open primaries to nominate their candidates. In the same year, fewer than 40% of the delegates to the national conventions for picking presidential candidates were selected by primaries.[38] As a result, there was the potential for real drama at the national conventions. Like a horse race, there might be a favorite, but it was frequently not clear who was going to win even as the convention was brought to order.

However, this relatively closed structure of top-down control was ill-suited to cope with voter sentiments in the later 1960s, a time of ferment and instability in US politics. Citizens across the nation protested the war in Vietnam, continuing segregation in the south and informal discrimination in the north, and, in time, discrimination against women and various minorities other than blacks, as well. The protesters against both America's involvement in Vietnam and its maintenance of segregated institutions tended to come from the political left, while counter-protesters came from the political right. As a consequence, the electorate became sharply polarized by these social issues in addition to more traditional economic concerns.

[37] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 182.
[38] Ibid.

Not surprisingly, the Democratic Party moved leftward as a result of these protest movements and, as the self-styled party of the working class, came under increasing pressure to incorporate women, people of color, and low-income workers into its leadership ranks. Faced with criticism of its nominating process in particular, the Democratic Party switched to the use of direct primaries, and the Republicans soon followed. Direct primaries enabled voters to choose the candidates themselves via the invisible hand of the ballot box. By 1980, more than 70% of convention delegates for the Democratic Party and more than 75% of those for the Republican Party were similarly selected, and subsequently both parties have reached the 80% threshold, with profound effects.[39] National conventions lost their suspense and instead became pageants showcasing the candidate who had won the primaries. In addition, the nominating process increasingly favored those candidates deemed able to win the primaries, thereby pulling both parties toward their bases and away from independent voters in the center. And, by the same token, the party leadership was shorn of much of its power. It was increasingly the winning presidential candidate who set policy for the party rather than the other way around, and thus the time horizon for goals and policies was radically shortened to the election cycle of the winning candidate.

But why did these changes suddenly take hold in the late 1960s? Beyond the general instabilities of the time period, the defining cause can be traced to the Democratic National Convention in Chicago in 1968. The year 1968 was not an ordinary year, either in the United States or abroad. Some 9,500 American servicemen were killed in Vietnam in the first 6 months, more than in the previous year. The Vietnamese mounted the Tet offensive in which they briefly took over some major cities. Martin Luther King, Jr. was assassinated, and then Robert Kennedy as well. Over the next few years, riots at universities forced out a number of incumbent presidents, for instance at Berkeley, Columbia, and Harvard. Overall, in 1968, there were 83 deaths due to major domestic disturbances, a number that dropped to 19 the following year and averaged about the same for the next 3 years.[40]

As the Democrats convened, just weeks after the assassination of Robert Kennedy, a three-way contest had been reduced to two, exacerbating party tensions and bitterly dividing the convention. Hubert Humphrey, who had declined to campaign in the primaries, was seen as a stand-in for Lyndon Johnson, who had withdrawn because of his leadership in a very unpopular war. Eugene McCarthy had done well in the primaries, lost to Robert Kennedy in the hugely important California contest, but then found out that Kennedy had been assassinated that same evening. McCarthy subsequently inherited much of Kennedy's support, but lost out in a convention complicated by bitter challenges over which delegates to recognize after the assassination.[41] Meanwhile, the party elders wanted Humphrey, a more

[39] Ibid., 183.

[40] Nelson W. Polsby, *Consequences of Party Reform* (Oxford: Oxford University Press, 1983), 17–18.

[41] Ibid., 19–25.

centrist candidate, believing he had a better chance in the general election. The eventual selection of Humphrey by the party elders led to street protests, riots, tear gas, arrests, police violence, and a humiliating public spectacle that was hardly a favorable send-off for the candidate, who went on to lose a very close election to Richard Nixon.

To repair this apparently broken process, the Democrats created a commission to propose reforms; it was headed first by George McGovern, from its left wing, and then by Donald Frazer. The commission recommended that all delegates to the national conventions be selected either by state caucuses open to *any* party member, and not just bosses, or that they be selected by open primaries. Once these recommendations were approved, the caucus form of selection was given added importance, with Iowa's voting chosen to occur first.[42] Iowa was a caucus state, meaning that potential voters had to come and spend time in a meeting listening to the views of their neighbors before voting. This might require anywhere from half an hour to several hours. And since the Iowa caucus was held in January, there might be snow or rain. Under such circumstances, those most likely to attend were the party faithful, i.e., its left wing. Iowa would thus give initial momentum to left-wing nominees, which was what McGovern and the left wing of the Democratic Party wanted. The Republican Party would not lose much time in making a similar change, and likewise cede power to its right-wing political base.

Reform of the nomination process led to profound changes in who was elected to various legislatures, especially the US Congress. With typically only a 20–25% voter turnout for primary elections, open primaries favored candidates from the "faithful" or base of the respective parties. As a result, fewer centrist candidates reached the general elections and fewer centrists made it to Washington.[43] With a shrinking political center, it became much more difficult to create bipartisan coalitions to enact legislative compromises, and thus much harder to govern from the center.[44] The traditional final coordinating mechanism, whereby members of the two parties from both houses might negotiate with mutual respect in a conference committee to arrive at outcomes somewhere in the middle, worked less and less well. In general, the aforementioned "democratizing" changes to political institutions made it increasingly difficult for legislators to come to agreements in a way approximating the coordination of the invisible hand of an economic market. Whereas the price mechanism tends to bring numerous buyers and sellers toward equilibrium in the middle, open primaries created polarization at each stage of the process, for instance, tempting parties to energize the extremes and thus bring out their votes, even at the expense of centrists.

Polarization reached eventually into the executive branch. Richard Nixon was the last Republican president to embrace centrist policies such as environmental protection and the earned income tax credit. Ronald Reagan, ably assisted by Alan

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[42] Ibid., 34–35.

[43] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 183.

[44] Ibid., 184.

Greenspan as chairman of a commission to reform the Social Security system, ushered in a new kind of politics for the Republicans where the economic agenda came from the hard right. George W. Bush moved it even further to the right, by adding a strong, so-called “values-oriented” social agenda that catered to the party base to ensure higher turnout. It was the same trend begun in the late 1960s by the Democrats. However, political markets did not work quite like their economic analogues. Whereas economic markets typically yielded a consensus price somewhere in the middle, political markets could be manipulated through the nomination process to yield results at the extremes, with little or no regard for the voters in the minority party, let alone those near the political center.

Before examining this structural issue in detail, consider some examples from democracies elsewhere. Most European democracies have quite different institutions, starting from the selection of their candidates for office. Their systems are based upon the sovereignty of a parliament, rather than sovereignty divided among three branches, and their majority parties choose the chief executive from their own elected membership. This allows for experience in governing prior to selection for top offices and for more party discipline in Europe. However, it means that there is less opportunity for “new blood” to run successfully for office, since none of the parliamentary democracies seems to have surrendered party authority to control nominees.[45] Britain, Canada, France, and Germany, among others, have all retained party control of the franchise; no one may run using their party label without the assent of the party regulars. This gatekeeping function makes it easier to maintain discipline in terms of adherence to the party message, and the parliamentary systems of Europe thus tend to have more cautious, ingrown candidates with more experience. At the same time, nominations for office are more attractive because candidates need not spend so much time or money running for office, as they are typically subject to only one round of electoral scrutiny. In addition, that one round of competition tends to pull the electorate to the center, like an economic market.

In stark contrast, US candidates of both parties must first pass through the gauntlet of their own party primary. To win in this preliminary battle they need personal name recognition, a skilled team of advisors to craft a media message, and a lot of money to finance not one but two campaigns. A fundraising shortage is quickly noted in the press as a sign of a weakness, and can be fatal to a campaign. Thus, although party relinquishment of the gatekeeper role may have been intended to make nominations more democratic, there have been many unforeseen side effects, starting with the fact that it helps to be rich when it comes to financing a campaign. While this more “democratic” candidate selection process promotes candidate choice and innovative ideas, it also promotes more inexperienced candidates who often represent ideological extremes. Furthermore, lacking the publicly funded TV time of their European counterparts, US candidates who do not shy away from the limelight still have to pay for it. This means that private individuals or interest

[45] Ibid., 182.

groups who can bankroll a candidate, either through their own funds or by running fundraising activities, wield considerable influence in the American political process.

The new, “more democratic” system has made much of the competition in the primaries about who can raise the most money to finance 30-second spots with highly tailored and often negative messages. This means that candidates are highly dependent on support from the electronic media and on donated funds for political success, and as a result they will almost surely find ways around any schemes to reform the campaign finance system, such as limiting campaign contributions. In short, instead of more open democracy, the United States has effectively achieved “checkbook democracy” through a system of public auctions (through so-called earmarks in part) and privately financed media exposure. The Internet is democratizing this process in terms of the number of contributors, but a candidate needs someone with the skills and initial capital to run such a fundraising effort. Figure 14.5 illustrates the fundraising trends in the United States.

There are several angles from which to analyze the historical data on campaign contributions in the United States. While the amounts of money raised have risen sharply in real terms, they have not risen as rapidly relative to GDP, which includes population growth as well as increases in productivity and incomes. On the other hand, the number of offices sought has stayed essentially the same, so the demands on candidates to raise money have increased dramatically. Arguably, the constant pressure of such fundraising is one of the reasons that “good people” have left public office voluntarily. In Zakaria’s words, “Almost all of them have left saying that the political system has gotten out of control.”[46]

Opening up Congress: Reforming Committees, Inviting in Lobbyists (Reforms 2nd and 3rd)

A second set of changes to the political system has affected how the Congress works. The same tide of democratization that affected the primaries, plus the Watergate scandal and the impeachment of a sitting President in 1974–1975, created some special circumstances that allowed newer members of the Congress to reduce the powers of their elders. Increased transparency and democracy were, once again, the overarching goals, while a closed system run by a collection of apparent elites—the committee chairs of the House in particular—was, also once again, the overarching enemy. As Thomas Mann and Norman Ornstein, authors of *The Broken Branch* and long-time congressional scholars and participants (having arrived as congressional fellows in 1969) relate that, by the 1970s, “The power of the committee chairs in the House, by rule and custom, was breathtaking. Committee chairs could hire and fire the staffs, set the jurisdiction of subcommittees and refer—or not

[46] Ibid., 169.

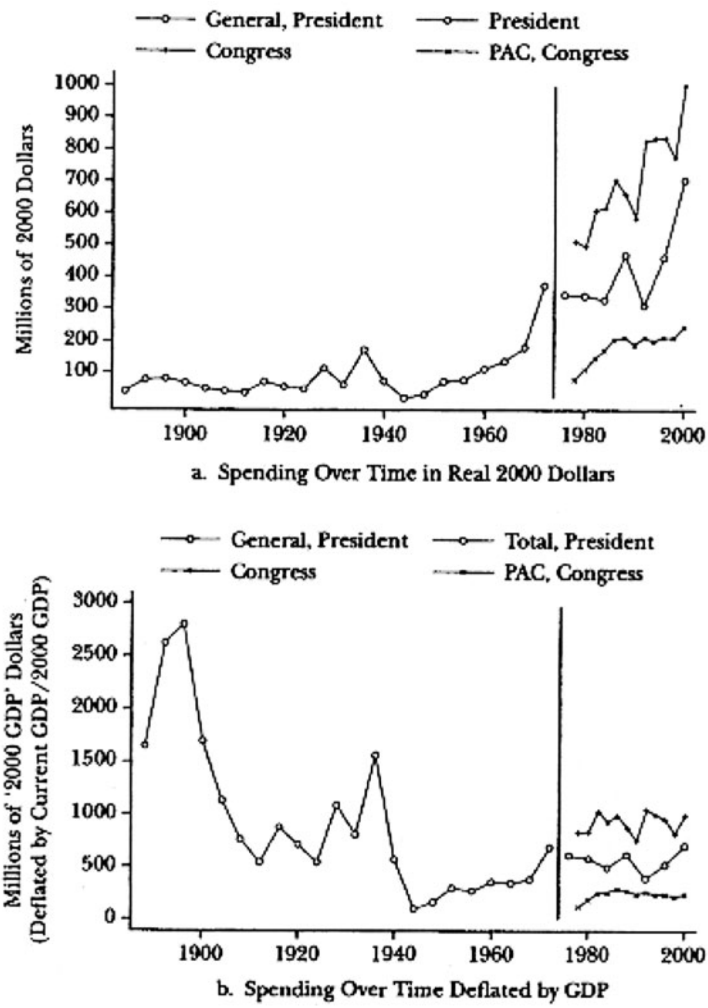

Fig. 14.5 Campaign contributions in the United States, in constant dollars and as a share of GDP. Source: Stephen Ansolabehere, John de Figueiredo, and James M, Snyder, Jr., "Why Is There So Little Money in U.S. Politics?" *The Journal of Economic Perspectives* 17, no. 1 (Winter 2003): 120, Figure 1

refer—legislation to them, choose the subcommittee chairs and often set the subcommittee memberships, select members of conference committees that ironed out differences between House and Senate bills, call committee meetings and hearings, decide whether members of the committee could travel, and control debate on the floor when committee matters came up."[47]

[47] Thomas E. Mann and Norman J. Ornstein, *The Broken Branch: How Congress is Failing America and How to Get it Back on Track* (New York: Oxford University Press, 2008), 53.

Symbolic of this old system of House elites was the power of Representative Wilbur Mills, a Democrat from Arkansas, who in 1974 had been chairman of the House Committee on Ways and Means for 17 years. As an authoritarian chair as well as a master of both the details of the tax code and legislative procedures, Mills had modified the structure of his committee to give Republicans an almost equal share of seats on the committee, despite their much smaller share in the House itself. He then adopted the practice of holding all "mark-up" sessions in the committee as a whole, behind closed doors, and with no subcommittees. Since he allowed Republicans to be over-represented in these sessions, they had little reason to complain. Once agreement had been reached behind closed doors, Mills ensured it would succeed without further modification from the greater House proceedings. Specifically, "he took tax bills to the floor under ground rules that barred floor amendments, and the full House regularly passed the bills by wide margins."[48]

Not surprisingly, Mills and his inordinate political power were natural targets for reformers seeking to open the legislative process to the public or, as Mann and Ornstein so aptly put it, "democratize the House."[49]

Their opportunity for reform came in October 1974, when the Capital police stopped Mills for erratic driving. One of his passengers, a "dancer" identified as Fanny Foxe, ran from the car to avoid arrest and fell into the Tidal Basin. Mills and Foxe made the news the following day. While this indiscretion might have been overlooked, Mills was spotted a few weeks later in Boston with the same companion, and this time he was obliged to apologize, admit that he was an alcoholic, and enter a treatment program. He resigned his chairmanship and left the House when his term expired. With his departure, the House would not be the same.[50]

The size of the Ways and Means Committee was soon increased, with almost all Democratic additions. It began doing business in subcommittees whose meetings were open to the press and lobbyists. And the right to bring bills from these subcommittees to the floor under a closed rule became the exception rather than the norm. A similar set of changes soon swept the entire House. The number of subcommittees increased by about 50% and their powers increased as well, such that each member was able to initiate legislation, and each vote, in subcommittee or full committee, was recorded so the public could know who had voted for what.[51] Zakaria sums up the ultimately undemocratic implications of these changes well: "From an institution dominated by 20 or so powerful leaders, Congress has evolved into a collection of 535 or so entrepreneurs who run the system with their own interests uppermost—to get re-elected. The purpose of these changes was to make Congress

[48] "Mills, Wilbur," in *Electronic Encyclopedia of American Government* (CQ Press).

[49] Mann and Ornstein, *The Broken Branch: How Congress is Failing America and How to Get it Back on Track*, 64.

[50] "Mills, Wilbur."

[51] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad,* 170.

more open and responsive. And so it has become—to money, lobbyists and special interests."[52]

Congress also changed some of its key operating procedures to make them more transparent, but once again the reforms amounted to deregulation, decreasing the coordinating powers of a few key leaders. This increased transparency, or "sunshine" as it is called, has a simplistic appeal; it makes sense that the public's business should be done in public[53] if one assumes that more transparent government *by* the people ensures government *for* the people. But this logic becomes a cover for abuse; shining sunlight on the system politicizes every vote, whether procedural or substantive, and opens the process to photos and sound bites that can be packaged as 30-second television commercials. The public is then sold its political information in much the same way as its information on beer or fast foods. Arguably, the public has little understanding of what is happening when it comes to the legislative processes; the subject matter is too complex to follow without some study, and most people do not have the time or the interest let alone the training to do so.

In such a context coordination is achieved through economic power where special interests dominate, sending a lobbyist to observe every vote at every subcommittee session. Money has become the coordinating force that seniority and committee structures used to supply. While intense public scrutiny does not affect a legislator's salary, it does affect his or her ability to raise money to be competitive in the next campaign. No matter how much money a politician has raised, more is always helpful; potential donors can have access to power by subtle gestures that imply blacklisting an incumbent for a single "wrong vote." And these potential donors tend to be quite partisan, such that their tacit influence via lobbying worsens the polarization already noted above.

Mann and Ornstein look back on the transformation of Congress to its political extremes and summarize it well: "American democracy has been deeply affected by the rise of the most partisan era since the late nineteenth and early twentieth centuries. This is an era characterized by strong and ideologically polarized parties competing from positions of rough parity. These features of the party system are evident among elected officials in government and in the electorate. They are reinforced and strengthened by teams of aligned activists, interest groups, community organizations, and media outlets."[54] Zakaria makes a similar diagnosis, pointing out, "reforms designed to produce majority rule have instead produced minority rule."[55] The minorities here are the same as the "teams" referred to by Mann and Ornstein, i.e., special interests that are well organized and financed, often by the contributions of corporations and well-to-do individuals; the majority is the disenfranchised public.

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[52] Ibid., 171.

[53] Ibid.

[54] Mann and Ornstein, *The Broken Branch: How Congress is Failing America and How to Get it Back on Track*, 224.

[55] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 171.

How many such people are there in Washington to monitor the workings of the government? According to Zakaria there were 5,000 lobbyists in 1960, 10,000 by 1970, and 20,000 by 1990.[56] That comes out to almost 400 lobbyists per member of Congress, with the numbers continuing to grow. And consider what they have to offer, besides advice and counsel on potential legislation. Campaign contributions from the 50 largest donors, all of whom were organizations of one sort or another, totaled over $1 billion during the period 1989–2009.[57] How much political "voice" did lobbyists have compared to the average voter? Are the political donations of corporations, labor unions, and other organized groups really political speech like that of individuals, or is this a gross corruption of the basic idea of equality of representation in a democracy?

Initiative Petition (Reform 4)

In another major change that also increased the influence of money in US politics during the late 20th century, the American public revived the use of the initiative petition as a form of popular or direct democracy. While the use of the initiative petition got its start in the 1890s, as discussed in Chap. 13, it returned to fashion in 1978. The catalyst was Proposition 13, a ballot initiative in California designed to roll property taxes back to their 1975 levels, to prohibit revaluations of property until after it had been sold, and to limit annual increases in tax rates to 2.5% per year. While it was initially opposed by the leading politicians in both parties, including former Governor Ronald Reagan, it passed by a 65%–35% vote. Since its success, the number of initiative petitions submitted in the various states has increased dramatically: 88 in the 1960s, 181 in the 1970s, 257 in the 1980s, 378 in the 1990s, and 204 in the year 2000 alone.[58]

While no doubt there have been some good ideas enacted through the initiative petition, its increased use has greatly reduced the power and authority of state legislatures without commensurately reducing their responsibilities. California, with its heavy use of this political tool, presents a perfect example. Since 1978, the state legislature's control over state spending was reduced to about 15% of the total budget while its responsibility for providing services remained the same; thus its responsibilities far exceeded its budgetary authority.[59] The unfortunate results of this mismatch in power and accountability were not long in coming but have proven difficult to repeal. In 2009, the State Supreme Court's Chief Justice, Ronald M. George, commented on the effects of the referendum:

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[56] Ibid., 173.

[57] Center for Responsive Politics, "The Top 100 Donors, 1989–2010" (OpenSecrets.org, December 2009), http://www.opensecrets.org/orgs/list.php?order=A. Figures are for 1989–2009.

[58] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 189.

[59] Ibid., 193.

> California's lawmakers, and the state itself, have been placed in a fiscal straitjacket by the steep two-thirds-vote requirement—imposed at the ballot box—for raising taxes. . . . Much of this constitutional and statutory structure has been brought about not by legislative fact-gathering and deliberation, but rather by the approval of voter initiative measures, often funded by special interests. These interests are allowed under the law to pay a bounty to signature-gatherers for each signer. Frequent amendments—coupled with the implicit threat of more in the future—have rendered our state government dysfunctional, at least in times of severe economic decline.[60]

In the 1950s and 1960s California was known as an innovative state whose system for providing public goods and services was in many ways a model for the country. But, thanks in large measure to the use of the initiative petition, by the 1990s it was at best a model for the under-provision of public services and inefficiency. Highways that had once been exemplars of efficiency became overcrowded and under-maintained. The state's education system fell from top-tier status nearly to the bottom, on a par with Alabama and Mississippi in terms of per pupil spending, test scores, and student skills. And instead of new university campuses, California provided its growing population with 20 new prisons built over 30 years.

David Broder of the Washington press corps studies California's failure in his book *Democracy Derailed*. He points out that the initiative petition was not a system of government built upon laws so much as a system of laws without government.[61] An ill-informed public voted for slogans that were created and packaged by slick marketing organizations and paid for by special interests. Voters did indeed have more power, but all too often they exercised this power without understanding the implications of what was being proposed. Voters supported tax cuts but were then surprised by reductions in services, having expected the cuts would be to reduce items such as "waste, fraud, and abuse." Nevertheless, voters still preferred to take power away from their elected representatives and give it to "the people," who could purportedly be trusted to do the right thing.

This increased utilization of direct democracy was doubly flawed; it gave power not only to an inadequately informed, uninterested public, but also to an educated, self-interested group of individuals including lobbyists, corporations, and the wealthy. In Zakaria's words, "perhaps the greatest paradox of the initiative and the referendum movement has been its unexpected relationship to money in politics. Initially devised to remove public policy from the improper influence, direct democracy has become an arena in which only the wealthiest of individuals and interest groups get to play . . . In California, in 1996 alone, more than $141 million was spent on initiatives, which was 33% more than was spent by the much maligned candidates for the legislature."[62]

The implications of both Broder and Zakaria's analyses are that recent reforms nominally intended to bring about government *by* the people have put much of US

[60]Chief Justice Ronald M. George, quoted in Jennifer Steinhauer, "Top Judge Calls Calif. Government 'Dysfunctional,'" *New York Times*, October 10, 2009.

[61]See Broder, *Democracy Derailed: Initiative Campaigns and the Power of Money*.

[62]Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 196.

democracy up for sale; from the auctioning of nominations for primary and general elections, to the opening of the legislature to highly targeted lobbying, to the opening of the legislative process itself, to the greatly increased use of the initiative petition. The result is government that is less *for the people*, despite the superficial trappings of popular democracy to the contrary. Whoever has the money to hire consultants, public relations experts, and marketing teams has the best chance to win nominations, elections, and initiative petitions. Support of the electronic news media was also pivotal, again based upon money that was typically confided to the hands of media conglomerates.

From this perspective, it comes as no surprise that the public feels that it can no longer trust the government. The public is right, of course, but it generally fails to recognize that the changes were made in its name, to make the system more transparent and responsive. Furthermore, it is difficult to see how to improve this system without making it appear "less democratic." Likewise, it is very difficult to see how anything seemingly anti-democratic has a chance of electoral success, given the power of television sound bites to steer the public toward premium beers, French fries, and their legislative equivalents. Until changes are made to "raise the bar" on the initiative petition process and reduce politicians' dependence on money, political entrepreneurs have a lucrative market in which to compete and exercise their undoubtedly undemocratic power.

All of the various political reforms discussed in this section are tied by this trend of democratization leading to outcomes that are, in fact, less democratic. Deregulating political markets from the 1960s onward led to further instability and the ultimate rise of money as the ultimate "voter" in the new market-based system. Letting markets decide political outcomes has effectively meant letting money have an increasing role in political outcomes; supply and demand can either be "distorted" by regulations and standards or be bought and sold by the interested wealthy. The same maxim holds in the social realm, discussed previously, and the economic realm, which I turn to below.

The Toxic Trio

The Toxic Trio: (1) Deregulation

Just as instability led to deregulation of the social and political realms, described above, it eventually led to deregulation of the economic realm as well. However, economic deregulation came from the conservative right as opposed to the far left that had led the social and political reforms. And the economic reforms seem to have been more carefully targeted to achieve very particular results. The heavily regulated welfare state set up in the 1930s was seen as restraining or distorting economic growth, while free markets were seen as an all-purpose remedy to all problems. From the 1960s onward, a series of poor economic policy choices by successive presidents seeking to skirt short-term problems exacerbated both the inflation and the sense of instability in the country.

In 1980 the Republicans campaigned on a platform of radical reform. It was not long before these reforms would undermine the social democratic model of capitalism that had prevailed since World War II and thus set the United States on a path distinct from that of its counterparts in Western Europe and Canada. Although the headlines of the time emphasized Reagan's tax cuts, his turn toward deregulation exerted a far greater long-term influence on the US economy. In order to put the nation's ongoing economic instability into proper context, we need to go back to Lyndon Johnson's administration to identify its origins and follow the trail of bad policies through Nixon, Ford, and Carter. Despite the fact that these policy mistakes were widely appreciated at the time, the underappreciated distortions that they helped induce in US capitalism were not so obvious at the time and yet have had long-lasting implications.

In the late 1960s, the budgetary bind that faced Lyndon Johnson was a familiar problem to economists: it was the need to choose between "guns and butter" (i.e., the war in Vietnam or the war on racism and poverty at home), or to raise taxes to finance both. President Johnson's dilemma was that he wanted to wage and win both wars at once without a tax increase, since the latter might induce Congress to scale back or refuse his Great Society programs. By refusing a tax increase to pay for the spending until it was too late to head off the resultant inflation, the US government decided to abandon fiscal responsibility. Paradoxically, Washington refused to accept the remedy that was soon to be known as the "Washington Consensus." The remedy was for other countries, but not for Washington itself.

Economic instability was not long in coming. Whereas US inflation had been only 1.3% from 1960 to 65, it was 4.3% for the next 5 years, 6.7% annually from 1970 to 75, and 8.9% for the remainder of the 1970s. The wage-price spiral plus the costs of the Great Society programs and the war in Vietnam led to a 50% rise in federal spending (in nominal terms) in 3 years (1965–1968), a 25% rise in tax revenues, and a resulting rise in the budget deficit of about 3.5% of GDP.[63] A tax increase in 1968 reduced these pressures temporarily, but renewed deficits and continuing cost-push inflation soon led to a balance of payments crisis in 1971 and a run on the dollar that summer. Unwilling to curb its payments deficit to avoid devaluation, the United States floated the dollar and abandoned the Bretton Woods System of fixed exchange rates, a key pillar of the postwar global economic system, opting instead for a necessarily superficial and fortunately short-lived program of wage and price controls.

These decisions, stretching from the late 1960s well into the 1970s, were exemplars of irresponsible fiscal policy, which built dangerously upon each other and yielded continuing repercussions. Notably, President Johnson's fiscal policies created an awkward problem for President Nixon and his staff. To restrain inflation and thereby avoid the need to devalue the dollar Nixon needed restrictive monetary and fiscal policies, an absolutely standard remedy in the yet-to-be-named Washington

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[63] *Economic Report of the President*, February 1971 (http://fraser.stlouisfed.org/publications/erp/issue/1214/download/5717/ERP1971_Appendixes.pdf), 271, table c-63.

Consensus formula. But restrictive monetary and fiscal policies were almost sure to cause a recession and thus jeopardize his chances for reelection in 1974. Faced with this choice, President Nixon decided to break the convertibility of the dollar and, with the consent of Japan and others, allow it to depreciate by about 10%. But his unwillingness to rein in the inflation meant that the run on the currency returned again in 1973. This time, the United States abandoned any notion of a fixed value for the dollar and allowed it to float. The discipline of a fixed exchange rate was incompatible with the expansionary policies that were needed to win elections. Quite simply, international financial order was overthrown because US authorities were unwilling to accept the disciplines that the system required.

The impeachment of President Nixon in 1974 and his resignation in the face of sure conviction and removal did not help restore order. An unelected Ford Administration, guided by a small group of little known government officials experimented with ephemeral ways to try to limit the balance of payments problems without constraining the inflationary pressures, thanks to the malign neglect of the Federal Reserve System under the leadership of Arthur Burns, thus permitting a growing overvaluation of the dollar and allowing the payments imbalances to continue with increasingly negative effects.[64] However, conservatives seized the moment to declare that the social democratic experiment, with its attempts to manage aggregate demand through fiscal policy, was bankrupt. It would have been a good deal more accurate to say that macroeconomic management, when manipulated for short-term political ends, under the gaze of a passive Federal Reserve System was bankrupt, but that would hardly have been news, let alone welcome news.

The Carter Administration then furthered the erosion of the dollar and the rise in domestic prices, as it too continued to temporize with inflation. Instead of a painful contraction of demand it tried to reduce inflation through reducing the protection of organized labor in industries such as airlines, railroads, and trucking. It was a worthy initiative, but a futile and inadequate one. Eventually, President Carter appointed Paul Volcker to chair the Federal Reserve, and Volcker was not long in changing the focus of monetary policy to one of reducing the growth of the money supply, inducing a dramatic boost in interest rates that brought a recession in 1980, on the eve of an election. Recognizing that this policy shift was negatively affecting the President's chances for reelection, Volcker abruptly but temporarily reversed course until after the election, when he returned to the fight on inflation with dramatic consequences.

Ronald Reagan was elected President in November 1980. Around this time, the United States was nearing the top of an inflationary spike that would soon be deflated by a monetary squeeze imposed by Volcker at the helm of the Federal Reserve. In that squeeze, short-term interest rates rose to 19%, or about 10% in real

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[64] See Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007).

terms. This was strong medicine. Rising interest rates meant falling asset prices, a drastic drop in corporate earnings, and a decline in the perceived job security of almost everyone in corporate America.

Despite this economic squeeze by the Federal Reserve, the Reagan Administration lost little time in proposing major economic reforms, adhering to Reagan's much publicized belief, shared by his key advisors, that government was the "problem not the solution."[65]

Jacob Schlesinger, writing for the *Wall Street Journal* in 1999, summarized the Reagan reforms and their deregulatory implications well: "Over the past two decades capitalism has burst into territory long off-limits to market forces. In the US, 'public services' like mail delivery and 'natural monopolies' like telecommunications have been opened to competition . . . After shedding public controls over telephones, airlines and trucking the country is currently undergoing the next great experiment in deregulation . . . Even the social safety net—the government's attempt to protect Americans against the most dire consequences of the market—isn't sacrosanct anymore. Not only have benefits been curbed, but more and more states are contemplating turning over the administration of benefits to private contractors."[66]

Reagan's policies marked the start of a new era of deregulation; free-market ideology appeared to permanently implant itself in US economic policy. This era of emphasizing deregulation, or markets, as governance has been actively continued, and by members of both parties. Markets will yield equilibrium, but the invisible hand of the pricing mechanism can only coordinate; it cannot govern. Governance means modifying the market frameworks to achieve more desirable results. Coordination takes place within a given set of market frameworks without changing them. Thus, the Reagan deregulation was the underpinning for the rapid rise of the financial services sector, with rapidly rising incentive compensation, inducing increased leverage and an increased concentration of wealth in this one sector, as we will see in the Epilogue. For instance, in a speech in 1994 to the National Association of Realtors, President Clinton emphasized his commitment to taking government out of the market and reducing its regulatory authority in general: "When I became President, we put together an economic strategy that was comprehensive in approach, long-term in vision, but quite basic: reduce the deficit, change the way Government works; make it smaller with less regulation, more efficiency . . . We have deregulated banking, deregulated trucking. We have gone a long way to deregulate Federal rules and regulations on States . . ."[67] Reaganomics thus became the economics not just of Reagan or of the Republican Party, but of America

[65] Ronald Reagan, "First Inaugural Address" (Washington, DC, January 20, 1981).

[66] Jacob M. Schlesinger, "Looking Ahead—Possible Paths: The Embrace of Capitalism Could Be Just Beginning—or Disappear in the Next Recession; A Case Can Be Made for Both," *The Wall Street Journal*, September 27, 1999.

[67] William Jefferson Clinton, "Speech at the National Association of Realtors Conference" (presented at the National Association of Realtors Conference, Anaheim, CA, November 5, 1994).

itself, as the mantra of most key political and economic leaders. Deregulation was not just a panacea, but a bipartisan panacea as well. But to what effect?

Again, the Book-of-the-Month Club tale serves as an effective analogy, ending much like the story of economic deregulation in the United States. As regulation went out the window, so did all sense of standards when judging economic outcomes, including that there might be a societal interest in trying to maintain a measure of civility in American life. Schlesinger referred to a loss of "civility" when writing a follow-up article on Reaganomics in 2002. In his view, US leaders had made a deliberate change in economic strategy and were quite conscious of its far-reaching implications: "From the 1930s to the 1970s, Washington embraced an ever-greater role for the federal government. But the economic stagnation of the 1970s convinced politicians in both parties that the pendulum had swung too far. By the end of the decade, Democrat Jimmy Carter launched the modern deregulation movement by freeing up the airline and trucking industries. His successor, Ronald Reagan, even more enthusiastically embraced the wisdom of markets over bureaucrats. The reforms, officials believed, would unleash innovation and raise living standards. Those good things did happen. . . . But the savviest policy makers knew they were making a choice 'between economic growth, with associated potential instability, and a more civil way of life with a lower standard of living' as current Fed Chairman Alan Greenspan recently put it."[68,69]

Was there really a conscious tradeoff for policymakers, as Schlesinger and Greenspan seemed to suggest? More recently Greenspan has indicated that no such tradeoff exists because, in effect, as the US increases its standard of living it can *buy* its civility from the proceeds. In his book *The Age of Turbulence*, Greenspan explains this process, as well as his notion of the free market, laissez-faire model of capitalism in which it is grounded: "Granted that open economic competitive markets foster economic growth, is there an optimum tradeoff between economic performance and the competitive stress that it imposes on the one hand, and the civility that, for example, the continental Europeans and many others espouse? But is there a simple tradeoff between civil conduct, as defined by those who find raw competitive behavior deplorable, and the quality of material life most people seek? It is not obvious from a longer term perspective that such a tradeoff exists in any meaningful sense . . . At a fundamental level Americans have used the substantial increases in wealth generated by our market-driven economy to purchase what many would view as greater civility."[70] Put simply, Greenspan is saying that even if civility were to decline with economic growth, such growth could and would permit society to buy it back.

Can civility really be bought? According to the *American Heritage* dictionary, civility is a form of "politeness or courtesy" extended by one person to another.[71]

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[68] Schlesinger, "Looking Ahead—Possible Paths: The Embrace of Capitalism Could Be Just Beginning—or Disappear in the Next Recession; A Case Can Be Made for Both."

[69] Greenspan, *The Age of Turbulence: Adventures in a New World,* 277–278.

[70] Ibid., 277–278.

[71] "Civility," in *The American Heritage Dictionary*, 1981.

The implication is that it is freely given and not bought. It is like love within a marriage, where both parties regard each other as part of a union that is intended to endure "for richer, for poorer, until death do us part." It implies a series of transactions that are voluntary, with no cash changing hands; in fact, civility would be undermined were conjugal transactions to be paid for. You cannot buy love and you cannot buy civility. There can be other transactions between men and women where cash does change hands, but they are not usually considered within the bounds of the marital vows or the civility that those vows imply. Does US wealth allow it to dispense with the importance of civility as a mode of behavior that no longer exists "in any meaningful sense" because it is no longer important?

A society devoted to a form of capitalism largely free from government oversight cannot expect either stability or civility in its social system. That is where regulation comes in, and almost surely at some cost, as Schlesinger implied and as Sumantra Ghoshal elaborates further below. Quality of life in Greenspan's formulation seems to be roughly equivalent to the quantity of consumer goods that one can buy. In this formulation, he surely was not alone. Laissez-faire capitalism was presumed to yield more GDP, which in itself would buy a more civil way of life, even if almost all of the increase in purchasing power went to the top 10%, as seen in Fig. 14.1, and none at all went to the wage of the median male worker, as shown in Fig. 14.3.

Examples of policies embracing this attitude, sacrificing long-term civility for short-term "efficiency," abound, long after the Reagan era had officially ended. Greenspan provides powerful examples, both in his academic writings and in his practices. In his writings, just as he rejected the notion that government can facilitate greater civility through regulation, Greenspan refutes the idea that government-sponsored regulation can be as effective as self-regulation by the private sector. Most notably, in 1997 he set forth his views on "The Virtue of Self-Regulation" in an 865-word article in the *Journal of Commerce*:

> Having been a bank regulator for ten years I need to be reminded that the world operates just fine with a minimum of us. Fortunately, I have never lost sight of the fact that government can undermine the effectiveness of private market regulation and can itself be ineffective in protecting the public interest. It is most important to recognize that no market is ever truly unregulated, in that the self-interest of participants generates private market regulation. . . . [T]he real question is not whether a market should be regulated. Rather, it is whether government intervention strengthens or weakens private regulation, and at what cost.[72]

Such aversion by Greenspan and his colleagues to regulation was not just theoretical. For instance, Congress had specifically empowered the Federal Reserve to regulate all mortgage lending activities in 1994 by passing the Home Ownership and Equity Protection Act of 1995 (HOEPA). The act explicitly stated: "The Board, by regulation or order, shall prohibit acts or practices in connection with—(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the

[72] Alan Greenspan, "The Virtue of Self-Regulation," *Journal of Commerce* (April 21, 1997): 11A.

provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower."[73] The Fed did not take advantage of this new power. Instead, the Fed arguably worsened the potential risks by promoting record low interest rates throughout the early 2000s, thereby making both credit and real-estate values seem cheap.

Greenspan knew that these policies entailed risks. The *Wall Street Journal* commented on Greenspan's logic and his uncertainty at the time: "When the Fed cut interest rates to the lowest level in a generation to avoid a severe downturn, then-Chairman Alan Greenspan anticipated that making short-term credit so cheap would have unintended consequences. 'I don't know what it is, but we're doing some damage because this is not the way credit markets should operate,' he and a colleague recall him saying at the time." Seven years later, in the midst of the emerging crisis of August 2007 (addressed at greater length in the Epilogue to this volume), Greenspan defended those damages in the name of free-market capitalism, claiming "'These adverse periods are very painful, but they're inevitable if we choose to maintain a system in which people are free to take risks, a necessary condition for maximum sustainable economic growth.'"[74] In short, the risks to civility were worth taking in the name of preserving free-market efficiencies and a higher rate of economic growth.

Beyond Greenspan and the Fed, the same tradeoff of deregulation in the name of efficiency occurred in Congress. Consider the deregulation of the financial services industry, with passage of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. The Act removed the barriers separating commercial banking (i.e., checking and savings accounts), investment banking (i.e., speculative trading), and insurance set up in 1933 by the Glass-Steagall Act. By enabling institutions to offer the full range of financial services, the act prompted a wave of mergers between commercial and investment banks; the investment arm of a bank could now draw upon funds deposited with the commercial arm in order to finance increasingly complex and risky mortgage securitization activities. It also permitted the issuance of mortgage instruments that were so complex as to make it easy for the issuer to mislead their customers in the name of customized deals that could not be readily compared with those of another lender. Deregulation in this case surely increased profits and, undoubtedly, certain bankers' standards of living; but what about civility? The crisis of 2008, to which the risky actions of newly freed investment banks heavily contributed, speaks directly to this point. Economics professor Joseph Stiglitz has raised just this issue: "As a result [of the Gramm-Leach-Bliley

[73] Home Ownership and Equity Protection Act 1994 (Title 15, Chap. 41, Subchapter I, Part B, Section 1539: Requirements for certain mortgages), Section L (Discretionary regulatory authority of Board), Part 2 (Prohibitions), Sub-parts A and B. Obtained from Cornell University Law School's Legal Information Institute, US Code Collection.

[74] Greg Ip and Jon Hilsenrath, "How Credit Got So Easy and Why It's Tightening," *The Wall Street Journal*, August 7, 2007.

Act], the culture of investment banks was conveyed to commercial banks and everyone got involved in the high-risk gambling mentality. That mentality was core to the problem that we're facing now."[75]

A final example of the lasting impact of the free market replacing previous standards of civility lies in the Commodity Futures Modernization Act of 2000. The Act encouraged risky economic activities by deregulating derivatives such as credit default swaps, CDS's, a form of insurance against defaults. However, CDS's were not restricted to "insurable relationships"; they could be purchased as a way to speculate on the future of any firm. And, unlike insurance, which was carefully regulated, CDS's were issued on a free or unregulated market. The nominal value of outstanding CDS's rapidly ballooned from near zero in 1999 into a $62 trillion dollar market whose trades and traders existed entirely outside the oversight of government authorities.[76] This was an insurance market where the issuer of the policy could collect a fee for a transaction, while putting little or no collateral aside to cover the potential cost in the event that the default occurred. According to author Charles R. Morris, this shift of activity toward the unregulated financial sector was so extreme that "by 2006, only about a quarter of all lending occurred in regulated sectors, down from about 80% twenty years before."[77] Economic activity was thus increasingly delegated to the unregulated and therefore far "freer" markets within financial services, where riskier activities could take place without constraint or oversight. Those who would originate mortgages were particular beneficiaries. Subprime mortgages had little or no need for documentary support. They were profitable and could be sold to investors all over the world.

Distributing risk was seen as equivalent to managing it. After all, even during the Depression, there had never been a real mortgage crisis in the United States and, as Congressional representatives repeatedly indicated in speeches and policy, allowing lower standards in the mortgage industry empowered poor people to buy homes and achieve the so-called "American Dream" of homeownership. Never mind whether the prospective buyer could afford the home. The same was true of intervention from the White House; more owners were evidence of the success of the "ownership society," as dubbed by the younger President Bush.

Given its lasting influence on so many US policies and policymakers, Reagan's wholehearted embrace of deregulation and free-market capitalism is, in my view, his most lasting and damaging domestic economic policy legacy. It was potentially far more important than his much-trumpeted fiscal policies, where the tax cuts of so-called "Reaganomics" were supposed to be self-financing from the increased growth. Since there was no compelling evidence of a long-term increase in economic growth, especially for the median male worker, as seen in Fig. 14.3, the importance of his tax cuts lay in attracting votes. In contrast, I believe that his

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[75] Joseph Stiglitz, as quoted in Marcus Baram, "Who's Whining Now? Gramm Slammed by Economists," *ABC News*, September 19, 2008.

[76] David Corn, "Foreclosure Phil," *Mother Jones*, July/August 2008, 41–43.

[77] Morris, *The Trillion Dollar Meltdown*, 54.

deregulatory changes during the 1980s have had a long-lasting impact, marking the start of a 25-year period of bipartisan support for sweeping liberalization of economic markets, as though markets could be efficient and disciplined as long as the market actors were just let alone to regulate themselves. The rationale was that unleashing markets would induce increased innovation and investment, and thus set the stage for more rapid growth. Yet, in the event, radical deregulation seems instead to have helped set the stage for slightly lower economic growth from 1980 through 2009, compared to the preceding 30 years (1950–1980); greatly increased inequality, instability, and incivility in the system; and ultimately for the financial crisis of 2008, as I will discuss in the Epilogue. There were many such regulatory changes, and they deserve serious study based upon a careful attempt to appraise what caused the financial meltdown.

But the Reagan era was also one of microeconomic change as well. These microeconomic aspects of the transformation toward deregulation and the laissez-faire model of capitalism are important because they give a clearer indication of how and to whom power was allocated, how it was used, and how it helped transform US business ethics. This takes us to the second and third pillars of the toxic trio.

The Toxic Trio: (2) Shareholder Capitalism

The deregulatory winds that swept through America's social, political, and economic realms altered not only the general shape of the country, but also the behavior of the individual actors within it. Notably, and most relevant to this discussion, they altered the driving logic and thereby the consequent actions of firms within most industries, and particularly those within the financial sector. And what was that new, driving logic? In the account of Robert Simons, Henry Mintzberg, and Kunal Basu, the Business Roundtable, a blue ribbon group of the nation's largest firms, stated this new logic quite clearly in 1997, and in a way that was emblematic of a quintessentially American view:[78]

> Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and future stockholders over the long-term. Others claim that directors should also take into account the interests of other "stakeholders" such as employees, customers, suppliers, creditors and the community.
>
> The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. . . . In the Business Roundtable's view, the paramount duty of management and boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders."[79]

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[78] Henry Mintzberg, Robert Simons, and Kunal Basu, "Beyond Selfishness," from *MIT Sloan Management Review* 44, no. 1 (Fall 2002): 69, © 2002 by Massachusetts Institute of Technology. All Rights Reserved. Distributed by Tribune Media Services.

[79] *Statement on Corporate Governance*, White paper (Washington, DC: The Business Roundtable, September 1997), 3.

This is a remarkably clear statement of the stockholder or shareholder view that became so characteristic of US firms in the 1990s. Its potential significance can be better appreciated by comparing it with an earlier statement from the same group. In 1981 the Business Roundtable's "Statement on Corporate Responsibility" recognized that "'Balancing the shareholder's expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholder must receive a good return but the legitimate concerns of other constituencies (customers, employees, communities, suppliers and society at large) also must have the appropriate attention. . . . [Leading managers] believe that by giving enlightened consideration to balancing the legitimate claims of all of its constituents, a corporation will best serve the interests of its shareholders.'"[80] This view of stakeholder capitalism is consistent with the view expressed in this book that governance is a balancing of the empowerment of firms to earn a decent return and the regulation of their behavior in the interests of other societal stakeholders.

However, by 1997 the approach to business that balanced multiple constituencies' interests had been effectively repudiated: "The notion that the board must somehow balance the interests of stockholders against other stakeholders fundamentally misconstrues the role of directors. It is moreover an unworkable notion because it would leave the board with no criteria for resolving conflicts between the interests of stockholders and other stakeholders or among other groups of stakeholders."[81]

Shareholder capitalism was entrenched in a new set of ideas from financial economics, wherein it is the duty of managers to see themselves as the agents of the stockholders, since the latter are the true "owners" and thus "principals" of the firm, holding an interest in its residual income. Any use of funds other than for the benefit of these shareholders was considered illegitimate. This new set of ideas on "agency theory" was spearheaded by Michael C. Jensen, initially a Professor at the University of Rochester and then at Harvard Business School. As he and William H. Meckling described in a seminal paper from 1976, in "the agency conflict between the owner-manager . . . the most important conflict arises from the fact that as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls . . . [and] it can result in the value of the firm being substantially lower than it otherwise could be."[82] The idea that senior managers might have a duty to use their powers responsibly, in return for a salary, seems quaint if not naïve to agency theorists, and the idea that these powers might be used for any purposes broader than that of exclusively serving the shareholders in their respective firms is seen to be irresponsible. The same appeared true for the idea that managers would do their job based on internal motivation or drive; Jensen and his colleagues were essentially arguing

[80] *Statement on Corporate Responsibility* (New York: Business Roundtable, October 1981), 9, quoted in Mintzberg, Simons, Basu, "Beyond Selfishness," 69.

[81] *Statement on Corporate Governance*, 3.

[82] Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): 337.

that, without specific financial incentives, top management could be expected to be selfish slouches. The notion that building and maintaining a reputation for effective management might constitute adequate motivation was hardly worth mention.

Jensen's version of "agency theory" soon became the rationale for, if not the driving force behind, the broader theory of shareholder capitalism. And, as such, it became entrenched in the American business world through the turn of the century and up to today, as evidenced by its presence in many business school curricula and in the writings of notable academicians. Mark Roe, a professor at Harvard Law School, for instance, articulated Jensen's agency theory when studying country patterns of shareholder capitalism, based upon more or less concentrated ownership, over 20 years later, in 2000. He observed: "Diffusely-owned public firms must make managers loyal to shareholders. Agency costs arise because managers have agendas that differ from shareholders' agendas. Diffuse shareholders want the firm to maximize profits; unconstrained managers often prefer to maximize the firm's size, to avoid severe but potentially profitable risks, and to defer hard, disruptive actions . . . Managers, for their own reasons, not only frequently delay these restructurings, but also have a long-known propensity to expand the firm's ongoing operations, even at the cost of shareholder profits; their expanding the firm down a known path usually favors themselves and current employees, but it often fails to maximize shareholder profits."[83]

This is a wrong-headed statement from start to finish. It presumes the shareholders are somehow the ultimate principals or source of the power of the firm, which is, in my view, simply mistaken. The powers of a firm come from a charter granted by a legislature on behalf of society. A charter grants powers to firms that no shareholders are permitted to grant, such as the right to lock up the funds indefinitely or the right to limit shareholder liability in the event of bankruptcy. This fundamental distinction is easy to overlook in the United States, where the states compete with one another to ask the minimum from the grantee in return for such charters. With 50 states competing to grant charters in return for fees, no one is looking out for the public interest in the US context. It is a nuance overlooked by Jensen and his financial economists.

Beyond academic writing on the theory of the firm, Jensen's ideas became solidified in managerial practices, namely, as a natural way to rationalize increased compensation for top executives. The latter needed financial incentives to get them to perform the job that they had been hired for, i.e., to encourage them to act as agents of the shareholders. Accordingly, financial incentives based on this particular notion of agency theory were institutionalized with the increasingly popular use of incentive compensation through generous stock option packages. As Harvard Business School Professor Robert Simons describes it, "corporations have been urged to ignore broader social responsibilities in favor of narrow shareholder

[83] Mark L. Roe, "Political Preconditions to Separating Ownership from Corporate Control," *Stanford Law Review* 53, no. 3 (December 2000): 542–543.

value; chief executives have been regarded as if they alone create economic performance."[84] While CEOs do indeed have the capacity to block effective action within an organization, they cannot create strong economic performance on their own. They need to inspire and guide the efforts of others to achieve strong results.

But fear can also inspire a belief in agency theory, as an alternative to inspiration and leadership. Agency theory did not take hold in ordinary circumstances, and it did not catch on all by itself; it needed the initial aid of external catalysts, two of which came with the sharp decline in the value of stocks that accompanied the rising oil prices and inflation during the early 1970s. Low price-earning multiples meant that shares packed a huge upside potential if the market recovered, regardless of the relative performance of the firm. With listed firms selling on the stock market for less than half of their replacement cost (as measured by Tobin's famous quotient or Q value) between 1974 and 1984, most firms had to become conscious of their stock price or risk a shareholder revolt or takeover. Thanks to acceptance of the market for corporate control via the stock market in the United States and Britain, firms in these countries in particular felt an added pressure to keep their share prices high. But what actions could they take? Jensen's writing provided a guide; these firms could adopt a new strategy based upon downsizing and distributing funds to shareholders, a positive rationale for a strategy of shrinking the capital base of the firm. According to business historians William Lazonick and Mary O'Sullivan, "Under these conditions, U.S. corporate managers faced a strategic crossroads: they could find new ways to generate productivity gains on the basis of retain and reinvest or they could capitulate to the new competitive environment through corporate downsizing."[85] It was a choice of corporate strategy, between "retain and reinvest" (i.e., using corporate cash flow to fund the long-term internal development of the firm) and "downsize and distribute" (i.e., selling assets, cutting jobs, repurchasing shares, and increasing the nominal profit per share). The latter won out, as it helped fend off takeover bids by acting much as the takeover bidder might, while allowing incumbent management to report higher returns on a smaller capital base while remaining in control of the firm.[86]

While effective as a defense mechanism, as Lazonick and O'Sullivan point out, this shift in strategy had much deeper implications. Basically, it implied increased emphasis on profitability relative to growth; divestitures of non-core businesses; and the return of resulting cash to the investors who could decide for themselves where to put these funds.[87] It was, effectively, a shift of focus toward the "capital markets" for guidance in managing a public firm; the shareholders, or ultimate owners, should be the free-market drivers of how the firm was run, even if their interests were focused on short-term success in the form of downsizing to raise

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[84] Mintzberg, Simons, and Basu, "Beyond Selfishness," 67.

[85] William Lazonick and Mary O'Sullivan, "Maximizing Shareholder Value: A New Ideology for Corporate Governance," *Economy and Society* 29, no. 1 (February 2000): 26.

[86] Ibid., 16.

[87] Ibid., 24.

stock prices. Since downsizing tended to generate cash for the firm, the implication was that some of that cash (and managerial effort to deploy it effectively) could and would go abroad, for instance, to China. The assumption, left unsaid, was that the US economy would always generate enough good jobs to keep its labor force not just employed, but suitably employed. Thus, this rationale favors capital versus labor, as the former can search for opportunity worldwide while the latter cannot. It is just one more instance where market equilibrium cannot be presumed to be in the public interest. This rationale for corporate governance will contribute to capital outflows on the one hand, and downward pressure on US wages on the other. The rise of Asian competition and the outsourcing of more and more high-value jobs to China, India, and Korea seem likely to make this rationale for corporate governance seem exceedingly naïve in years to come, a rationale that favors shareholders relative to labor, thereby furthering the growing inequalities in the US distribution of incomes.

Mark Roe, looking back in 2001, effectively summarized this connection between the merger & acquisition movement of the 1980s and the rise of shareholder capitalism: "In the 1980s, about thirty percent of America's Fortune 500 companies received takeover bids. This is an extraordinary number, indicating that shareholder power via takeover bids had to be on the minds of all large firm managers. The 1980s were also, consistent with the thesis here, arguably one of the periods of strongest product market competition. Not only were American manufacturing markets workably competitive, but international competition was, for essentially the first time, pounding every manufacturer that could not perform. Hostile takeovers were, and . . . still are, an engine of shareholder wealth maximization."[88]

In the late 1970s and 1980s US firms were facing takeover threats not unlike those facing European political entities in the period 1500–1800, when the hostile takeovers of states became a decisive factor in their governance. Indeed, in Chap. 5, I argued that hostile takeovers carried the risk of execution for the leaders in the political entities that were taken over, and as a result political leaders were motivated to try to improve the performance of their territory lest they fall victim to a hostile takeover. It was just such pressures which motivated "more friendly" mergers as well as the decentralization of power in their domains to improve performance which was recognized as a route to being able to afford a bigger army. In the contemporary US circumstances, these pressures forced US firms to consider a radically different strategy than their analogs in countries other than Britain, which had a similar market for corporate control, i.e., strategies of downsizing and divestment to raise share price to avoid takeover. This was in marked contrast to Germany and Japan, which had no such market, and even to most other countries, which were in between these extremes.

Enhanced competition in the product markets was another contributing external factor to the rise of Jensen's agency theory and the resulting theory of shareholder capitalism. The 1980s was a period of unusually strong product market competition

[88]Mark L. Roe, "The Shareholder Wealth Maximization Norm and Industrial Organization," *University of Pennsylvania Law Review* 149, no. 6 (June 2001): 2074.

in the United States, thanks to high interest rates and an overvalued dollar. In addition, market structures had also changed. Whereas many American markets for manufactures had been quasi-protected by the special characteristics of US markets, i.e., a lucrative market existed for large gas-guzzling autos because gasoline was so much cheaper in the United States than in Europe or Japan, leaving US firms with a profit sanctuary in large cars. But in the 1980s international competition was, for essentially the first time, also pounding every manufacturer that could not perform. High interest rates and an overvalued currency enhanced this vulnerability, and for reasons that were mostly no fault of their own.[89] Firms thus faced further pressure to boost the apparent efficiency of their operations and reduce investments in the United States to keep their earnings and share prices high.

Hence the rise in popularity of Jensen's agency theory from the 1980s onward, ready to fill in the logical gap and rationalize the shift of focus to stock prices. Of course, this shift ultimately meant emphasizing the short-term interest of the typical shareholder, or the quintessential capitalists of Wall Street, over the interests of the more prosaic folks of Main Street. Managers were the agents of the shareholders and at all times were to act in the latter's best interest, with only second-order concern, if any, for the interests of other stakeholders in the firm, and notably rank and file labor. Proponents of the change—including institutional investors, agency theorists, and boards of directors—viewed a singular focus on maximizing shareholder value as a means to improve corporate governance, the societal allocation of capital, and, coincidentally, their own compensation as well. Agency theory, spurred by necessity during the M&A movement, thus transformed the nominal purpose of the firm from one oriented toward advancing stakeholder interests, and thereby the interests of society as a whole, to one much more tightly focused on the interests of shareholders and, when coupled with incentive compensation, corporate insiders meaning mostly top managers themselves.[90]

Of course, agency theory and shareholder capitalism were seen as beneficial to business management practices. Agency theory was conceived to be a way to make managing a firm simple; once managerial incentives were focused on shareholder interests, i.e., raising the share price, all other managerial decisions and acts would fall into place based upon the extent to which they supported that basic proposition. Having a goal expressed in a single, quantifiable dimension eliminated any potentially difficult choices about how to compromise among conflicting goals, thus reducing the job of the board and CEO to a rational calculation like a "science," or perhaps even an exercise in arithmetic. However, this meant that other, quite useful longer-term objectives, such as the interests of society itself, were downgraded or simply abandoned as the single standard of the stock price prevailed.

The US context made this narrowing of purpose easy, and almost an inevitable outcome. Since the charters of US firms came from states that were competing with

[89] Ibid.

[90] Lazonick and O'Sullivan. "Maximizing Shareholder Value: A New Ideology for Corporate Governance," 14.

one another to attract firms and their registrations fees, the charters demanded little or nothing in return. In contrast, most countries had only one source for such a charter, and the quid pro quo was typically to run the firm in the interests of the broader society in whose name the charters were granted. The US race to the bottom in chartering firms had long-lasting implications for the distribution of power in society as well as the governance of firms, and indeed the distribution of income within society as well as within the firms. Of course, shareholder interests must be considered if a firm is to survive let alone prosper, but beyond that there is room for discretion. Why should all of that discretionary cash flow accrue to shareholders, who as a class of interested parties probably had the shortest-term commitments to the firm of any of its stakeholders? While the shareholders at any moment were the formal owners, they were not owners in the sense that they owned their homes or their cars.[91] For instance, they could not be counted on to help a firm survive in the event of a crisis. Indeed, many could be expected to "cut and run" at the first hint of trouble, in just the pattern of the amoral opportunist. Shareholder capitalism is a way to degrade the ethics of a society to the level of a race to the bottom of maximizing short-term self-interest of shareholders over other claimants, most of whom had longer-term interests in the firm.

Shareholder capitalism has been buttressed by a theory of human behavior drawn from financial economics, a so-called universal theory built on individual behavior that has been developed without regard to social context. Maximizing shareholder value in a global economy is like encouraging managers to act like opportunists, for the benefit of their shareholders and to the neglect of other contributors, as explained immediately below. It is a profoundly amoral idea. Like Friedman's theory of self-regulating capitalism in Chap. 2, it merits some explication to understand how radical it is.

In a 2002 *Sloan Management Review* article, Henry Mintzberg, Robert Simons, and Kunal Basu criticize the "fabrication" that all people are merely economic men,[92] as advocated in Jensen and Meckling's 1994 article "The Nature of Man."[93] Jensen and Meckling suggest that the model of human behavior is best described as a Resourceful, Evaluative, Maximizing Model (REMM), with REMMs possessing yawning, endless wants and making tradeoffs for maximum gain. In advancing REMM, as Mintzberg, Simons, and Basu argue, Jensen and Meckling advocate for "dogmatic individualism," unconcerned with society:

> According to Jensen and Meckling, "there is no such thing as a need," except, of course, the need for more itself. Everything is a trade-off. They illustrate this with a rather startling example:
>
> "George Bernard Shaw, the famous playwright and social thinker, reportedly once claimed that while on an ocean voyage he met a celebrated actress on deck and asked her whether

[91] Ghoshal, "Bad Management Theories Are Destroying Good Management Practices," 79.

[92] See Mintzberg, Simons, and Basu, "Beyond Selfishness."

[93] Michael C. Jensen and William H. Meckling, "The Nature of Man," *Journal of Applied Finance* 7, no. 2 (1994): 4–19.

> she would be willing to sleep with him for a million dollars. She was agreeable. He followed with a counterproposal: 'What about ten dollars?' 'What do you think I am?' she responded indignantly. He replied, 'We've already established that—now we're just haggling over price.'"
>
> The story is not startling—it is, in fact, well known—but Jensen and Meckling's use of it is startling. For, instead of qualifying this in any way, they follow it with this statement: "Like it or not, individuals are willing to sacrifice a little of almost anything we care to name, even reputation or morality, for a sufficiently large quantity of other desired things. . . . " In other words, pushed to the limit, every woman—and every man—is a willing prostitute. Everything, everyone, every value has its price.
>
> Our quarrel is not just with the outrageousness of this claim, but also with its degree of truth. For while there are all too many such people in our midst, perhaps more than ever—too many athletes or financiers or university professors, willing to sell their integrity at some price—mercifully, that does not include everyone. For many people, integrity and self-respect are basic values. They are absolute needs open to no negotiation. Beyond material goods lies an inner sense of what is good. Beyond calculation lies judgment. Indeed, is this not the essence of responsible management? To judge the difference between short-term calculable gains and deeply rooted core values?[94]

But what is the place of "core values" in the US model of shareholder capitalism? In the paradigm of stakeholder capitalism, the values of the various stakeholders are entitled to consideration because they play a legitimate role in society and have given their tacit permission for the chartering of the firm to begin with. Consideration for various stakeholders is premised upon core values that are not for trade, let alone for sale, and, in addition, most stakeholders have no seat at the bargaining table. Those seats are mostly reserved for insiders.

The United States is not unique in its support for shareholder capitalism, but it clearly occupies the position of an extreme outlier among industrial societies, as American executives discover when discussing such issues in our classrooms. The rationale for shareholder capitalism in the United States comes in large measure from the peculiarities of its chartering system, itself a legacy of fears of undue power of the British crown at the time of independence, as discussed in Chaps. 7 and 13. The US chartering system imposes minimal demands on firms that apply, reflecting the understanding that any firm now has 49 other possible sources of such a charter, a uniquely fortunate bargaining position in the world economy.

The race to the bottom for the lowest standards of responsibility for chartering of firms is derived from an uncorrected element in the US Constitution. Recall Chap. 7, when James Madison suggested a federal right to issue charters, only to be advised that this would imply so much federal power as to imperil the ratification of the Constitution itself. And recall the efforts of Theodore Roosevelt and William Howard Taft, who tried for roughly a decade to secure a power of federal chartering in order to have a more potent system of regulation to offset the huge increases in power in the firms. All three failed in their efforts to secure a federal power of chartering, leaving the United States with a very lopsided regulatory process that

[94] Mintzberg, Simons, and Basu, "Beyond Selfishness," 68.

was long on the empowerment of firms and very short on imposing responsibilities on the recipients for the use of that power. The United States was surely a world leader in awarding power to corporations with minimal accountability expected in return. Indeed the United States may well have the lowest standards of responsibility for firms of any of the industrial countries. Is that what business schools should accept as an obvious standard, without comparative analysis with other countries? How many business school faculty have any idea of such a comparative indicator?

As we saw in Chap. 13, the firm gains its existence—in the form of its charter of incorporation—from the state, not from any individual, collection of shareholders, or other private organization. The right to mobilize power and to retain it indefinitely has never, in the history of the United States, sprung from shareholders, small or large, concentrated or widespread; it has always come from a state as the legitimate representative of society. Accordingly, for the firm and its managers to base their actions on maximizing the interests of the shareholders, to the neglect of other contributors to the welfare of the firm, is an exercise in abusing the powers that they have received. The firm must earn a return commensurate with its cost of capital, as essential to its survival and prosperity, but beyond this a firm should be run for the interests of a broad range of stakeholders, from employees to shareholders to suppliers to customers to society at large, all of whom contribute to its long-term well-being. To suggest otherwise, as in Jensen's version of agency theory, is to narrow the purposes of the firm to serving a very small group of participants, many of whom have little if any commitment to the long-term health or well-being of the firm, let alone to the well-being of society as a whole. Shareholder capitalism is little more than a way for a small group of insiders to rationalize their "take" from the firm. It helps corporate insiders rationalize the inequalities of income and power that have become characteristic of US capitalism since the early 1980s, as though these inequalities are somehow essential to the performance of firms. It is a view that seems based upon a very narrow conception that the value created by the firm is largely due to the top management, as though the bulk of the managerial personnel and others are of little import. And it overlooks the status barriers that are created by the extraordinary inequalities of pay that it supports within the firms themselves.

Shareholder capitalism reaches far into the fundamentals of the US economy; it shifts US capitalism toward the laissez-faire model with its oligarchic effects, both within firms and in the broader distribution of income. It helps concentrate power in the hands of a small elite allegedly in order to induce this elite to serve the true owners. At the same time, it provides a rationale for shifting control of capital allocation from Main Street to Wall Street. Indeed, it is a remarkable rationale for the centralization of power through capital allocation to a locale that has little connection with, or even understanding of, the processes of product development or of organization building, or the provision of a modicum of due process for the employees in how power is managed within the firm. In addition, it is a formula for emphasizing management by the numbers with little concern for intrinsic human values. In farming, this process was called a shift from an ownership-based system to one based upon tenant farming; the middle ranks of management in firms focuses on maximizing shareholder value have roles like tenant farmers, serving a master with no ownership stake in an activity. They are second- or third-class citizens in institutions run for the benefit of a tiny elite at the top.

The pseudo-scientific logic of shareholder capitalism seems to me to be little more than a means to rationalize the return of an oligarchic power structure; it is designed to yield a massive shift of power away from those who develop products, people, organizations, and high-quality services, to those who trade pieces of paper for short-term returns, or perhaps only derivative securities to bet on price changes without having to commit real capital. Professed loyalty to shareholders, who typically own their shares in US firms indirectly through mutual funds and the like, and for 12 months or less, legitimates reduced concern for all other stakeholders, including those who are the direct contributors to the welfare of the firm. In the name of increasing share price, management can treat employees much like commodities to be rented and discarded as indicated by short-term conditions. Indeed, such thinking helps the takeover artist rationalize the dismissal of any number of people in a target firm as if this action, which was best for the shareholders, and, thanks to the writings of Jensen and Friedman, best for US society as well.

Shareholder capitalism helps top managers rationalize a set of priorities where the firm is no longer seen as a societal institution where people have long-term careers and corresponding commitments to one another. As shareholder capitalism became an accepted norm, lifetime employment disappeared even for some of the firms that had been most committed to providing meaningful lifetime employment, such as IBM and Delta Airlines. Since shareholder principals, as they were called, often had virtually no connection with the employees of a firm that they might acquire, they need have little to no knowledge or concern for their welfare. Managers, ironically enough, were thus prioritizing and calling "principal" the segment of stakeholders whose interests were perhaps least aligned to the long-term interest of the firm. Shareholders were not owners in any meaningful sense; unlike owners in small firms who might tap their own bank account or even borrow on their homes if the firm needed cash, corporate shareholders could be expected to cut and run, ideally before others did likewise. Agency theory turned speculators into pillars of society.

Buttressed by agency theory, shareholder capitalism thus legitimized and perpetuated opportunism. First, it created an incentive structure perfectly suited to accepting opportunism as a standard of behavior for shareholders and, second, it took for granted and even encouraged opportunism as a standard of behavior for managers, all as if it were normal and even in the public interest. Shareholder capitalism encouraged opportunism among shareholders and managers via the mathematics of estimating future cash flows and stock prices, legitimizing a particular view of agency theory as objective, rational, and invulnerable to human bias or error. General management of firms was not to be taught in classes focused on corporate strategies and governance, but in classes in finance geared to the elucidation of the present value of future cash flows and their translation to share price. Whereas macroeconomics had reduced societal governance to the calculations of the effects of invisible hands in markets, microeconomics was now a similar, impersonal science of maximizing discounted cash flows to achieve the highest possible net present values for shareholders.

In this transformed context, firms became first and foremost producers of numbers to be valued on Wall Street, and the management of these numbers became a top priority in itself. Accounting rules and standards became the framework for thinking about the strategic variables for the guidance of firms, displacing the long-term interests of the firm in developing its technologies, market positions, or intangible values, and its people became more and more a disposable commodity. Companies were measured and valued quarter by the quarter. The single standard of share price—or market value—prevailed and, much like the standard of popularity seen in the story of the Book-of-the-Month Club, performance was to be judged by market values without regard for more subjective, intrinsic values.

Shareholder Capitalism and Business Education

Sumantra Ghoshal, in a remarkable paper on how bad management theory can lead to bad management practice, has pointed out that the managerial frame of mind encouraged by viewing shareholders rather than society as the principals, or by focusing on share price and thus short-term profit as the preeminent measures of value, does not promote sound corporate governance but rather undermines it. The agency theory of financial economics taught managers that they "cannot be trusted to do their jobs"[95] because they had been entrusted with a responsibility to do so for the benefit of all who worked for the firm. It transformed business into a science of aligning incentives, and thereby removed the need for moral and ethical considerations in management practice.[96] Thus, the pessimistic assumptions of "agency theory" became self-fulfilling, making the theory "the root cause of the recent corporate scandals in the United States," such as that of Enron.[97]

Unfortunately, this self-fulfilling pessimism is often driven home even before some managers reached an executive position. The financial version of agency theory infiltrated business schools during the 1980s and has been taught to more than a generation of managers.[98] As Ghoshal explains it, business faculty embraced the opportunity to make their teachings more objective; from the 1980s onward, they worked to turn the study of corporate performance and behavior from an overly "romantic" mix of individual choices and human agency, into a science of patterns

[95] Ghoshal, "Bad Management Theories Are Destroying Good Management Practices," 75.

[96] Ibid., 77.

[97] Ibid., 81.

[98] For an excellent history of why the early US business schools were founded and how they altered their purpose in the 1980s, see Rakesh Khurana, *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession* (Princeton: Princeton University Press, 2007).

and laws.[99] Students were taught in terms of maximizing net present values on the balance sheet, as the best indicator of share price, whenever possible. In less quantifiable areas, such as corporate governance or ethics, the message remained much the same; firms were to be run in the interest of the shareholders, as though these transient holders of equity securities were the equivalent of owners in a private firm.

In Ghoshal's view the educational challenge for US business schools was not to add a course in ethics, but to reduce the distortions resulting from existing courses focused on promoting quick gains. According to Ghoshal, business schools "do not need to create new courses; they need to simply stop teaching some old ones . . . In courses on corporate governance grounded in agency theory, we have taught our students that managers cannot be trusted to do their jobs—which, of course, is to maximize shareholder value—and that to overcome 'agency problems,' managers' interests and incentives must be aligned with those of the shareholders by, for example, making stock options a significant part of their pay."[100] Ghoshal notes similar problems in courses on organization design and strategy; agency theory has penetrated them all. It is the current curriculum and the distorted perspective driving it—i.e., agency theory focused on shareholder value to the exclusion of other concerns—that has been the problem and not the solution.

Rakesh Khurana, a faculty colleague at Harvard Business School, notes one effect of this switch in business education toward courses grounded primarily in agency theory and market ideology. Khurana described this change in terms of business schools "losing their way" to become much more like trade schools, forgetting all notions of the larger, less quantifiable picture, including the more human side of business. Ghoshal goes even further than this critique, arguing that business schools have encouraged and go on encouraging students themselves to "lose their way" as well. Instead of being taught to act ethically as managers, students are taught to resign themselves to their allegedly innate opportunism and to allow the mathematics of their job to direct it; instead of grappling with questions of ethics, they were taught to simply let a system of incentives, based on the mathematics of share price, guide their selfish nature to the appropriate outcome. The effect, as Ghoshal saw it, was to make managers feel that they were simply subject to market forces, needing no internal accountability: "I suggest that by propagating ideologically inspired amoral theories, business schools have actively freed their students from any sense of responsibility."[101]

Thus, business managers were taught, both by the economic pressures of the M&A movement and by the ideology of a very narrow form of agency theory that soon prevailed in their business schools, as well as the business world they would then enter, that the only standard by which they were to operate was that of shareholder capitalism or, rather, "share price" capitalism. What they felt was right and wrong for the firm and its various stakeholders, or even for society, was no longer

[99] Ghoshal, "Bad Management Theories Are Destroying Good Management Practices," 77.
[100] Ibid., 75.
[101] Ibid., 76.

valid. They were opportunists who could not be trusted to run the firm for the purportedly most important stakeholder—the shareholder—and must be incentivized accordingly. And the most notable means of incentivizing business leaders was the shift in executive compensation toward the granting of stock options. Luckily Congress would help them shoulder this lofty public purpose.

The Toxic Trio (3): Stock Options as Incentive Compensation

The 1980s saw a radical increase in the awarding of incentive compensation, eventually buttressed by a rationale like that expressed by the Business Roundtable in 1997: "Stock options and other equity-oriented plans should be considered as a means for linking management's interests directly to those of stockholders."[102] Beginning in the 1980s stock options radically altered the compensation systems of US firms from their own recent past; they also tended to make US firms quite distinct from their foreign counterparts. The idea behind incentive compensation, like that behind the adoption of shareholder capitalism itself, was to treat managers as if they had inadequate intrinsic motivation to promote the interests of the firm in return for their normal compensation, and inadequate sense of responsibility for how they used the power that had been entrusted to them as leaders of a firm. Focused incentives were needed to align the interests of managers and directors with those of the shareholders (not necessarily those of the firm). Incentive compensation in the form of stock options became popular across most industries, touted as the best means by which to motivate senior executives.[103] Stock options were allegedly tied to recognition of superior performance by the firms—as measured by stock price—and thus, presumably, to the superior performance of their CEOs. Rewarding managers with stock options and big bonuses tied to share price also promoted short-term gains, even if achieved at high-risks which later went sour; most firms made no provision to recover such bonus payments if the gains they were based on prove illusory later on. It was a "one way only" upside system to favor a privileged few.

As stock options became increasingly popular from the 1980s onward, the composition of the pay packages for US executives underwent a radical change, as indicated by Fig. 14.6. Most noticeably, CEO compensation increased dramatically relative to that of non-supervisory personnel, from about 30 to 1 in 1970 to about 400 to 1 by 1998, with most of the differential increase accounted for by stock options. Executive salaries and bonuses had risen handsomely but were still "only" about

[102] *Statement on Corporate Governance*, 6.

[103] I distinguish incentive compensation for senior executives from that for salesmen, because the performance of the former is so much more difficult to judge in any short-terms perspective, and so much more subject to manipulation of numbers. I also distinguish it from incentive compensation for groups of employees. Incentive compensation for senior executives presents almost insurmountable temptations to cut corners and/or game the numbers, and the bigger the incentives the more the temptation to engage in opportunistic behavior, or as an ultimate tactic, to cheat to make the numbers.

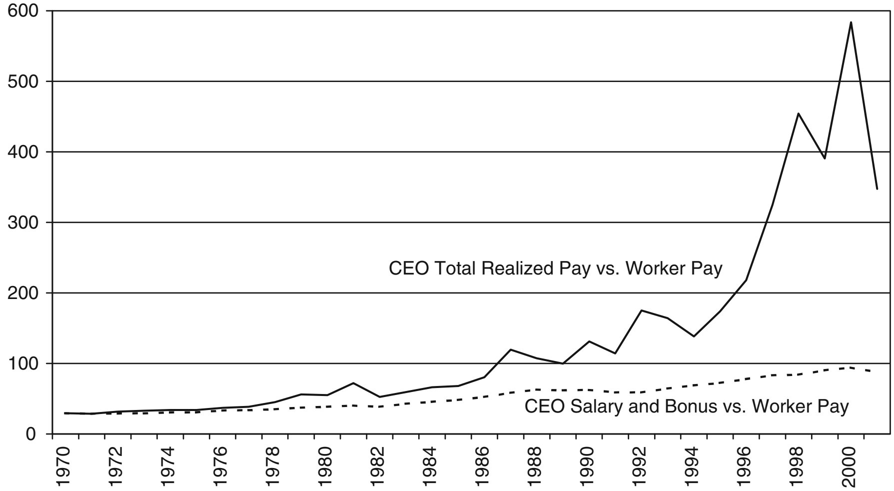

Fig. 14.6 US CEO compensation versus average pay for workers. Note: CEO sample is based on all CEOs included in the S&P 500 using data from Forbes and ExecuComp. CEO total realized pay includes cash pay, restricted stock, payouts from long-term pay programs, and the amounts realized from exercising stock options during the year. (Total pay prior to 1978 excludes option gains.) Worker pay represents 52 times the average weekly hours of production workers multiplied by the average hourly earnings, based on data from the *Current Employment Statistics*, Bureau of Labor Statistics. Source: For 1970 to 1996, see Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, Vol. 3, ed. Orley Ashenfelter and David E. Card (Amsterdam: Elsevier Science Publishers BV, 1999). Data for 1997 to 2001 were graciously provided by Professor Kevin J. Murphy

100 times those of their average employees; the remaining multiple of another 300, or 75% of total CEO compensation, came from the stock options alone. President Clinton was an unwitting accomplice in this process when, in 1993, he signed into law the Revenue Reconciliation Act, Section 13211 of the larger Omnibus Budget Reconciliation Act of 1993, which prohibited tax deductions of salaries over $1 million. Stock options were a way around this unwanted regulatory intrusion.

Options were a relatively new phenomenon; they had been authorized in the 1950s, were little used before the late 1970s, and then were widely employed in the 1980s and 1990s. How did stock options come to be used so widely? One quite practical reason was that they were a particularly attractive form of compensation in a rising stock market. The Dow Jones Industrial Average was about 800 at its low in 1981 and 11,000 at its peak in 2000, so the average price of a share rose more than tenfold in nominal terms over 20 years. The price rise was even steeper in the high-technology sectors listed on the NASDAQ. A tenfold gain in share prices was quite remarkable by any standard, but in this case, it did not imply that any particular firm had achieved superior performance relative to its competitors, only that it had grown along with the average firm. Thus stock options were particularly attractive for firms that were average performers or below. Their top managers could "share the ride" with the high-performing firms. A second practical attraction was that options could be granted at one price and exercised at a considerably higher price only a few years later. Even if firm performance did not improve, "a rising tide would lift all boats." While the payout on the options might be much larger than had been foreseen at the time of their granting, there were usually no provisions for scaling them back to account for windfall gains. Since the intended recipient did not have to put any money down in the interim period, this was a risk-free opportunity to make money, and lots of it.

However, the strongest practical attraction of stock options was that they did not have to be reported as a cost on the profit and loss statement; they were an "unusual charge" that was directly posted on the balance sheet as an adjustment to shareholder equity. In terms of their impact on current profits, they were "free."

Underlying these various practical benefits of stock-option compensation was the benefit of ideology, or namely, agency theory. Academic economists, led by Michael Jensen, defended stock options on the grounds that they increased the incentives to make managers think like owners, or shareholders, instead of bureaucrats, as discussed above. If the firm made more money and the share price went up, the top manager would be paid like an owner. Never mind that the executive was not necessarily an owner, with his or her own funds at risk, and never mind that declining interest rates were helping to boost the prices of all assets including bonds as well as common stocks. Options were allegedly offered to align the incentives of management and shareholders, despite the fact that they were based on a one-sided bet quite unlike any available to shareholders. They constituted a huge incentive to take risks with the funds supplied by the shareholders, but, unlike the incentive structure for the shareholders, the lucky managers need not put any of their own money at risk.

If such compensation schemes were, in theory and in effect, so distorted, why were they not stopped once these lopsided dynamics were recognized? The most obvious reason was that the agents who were monitoring the firms' profitability—and notably board members—were unlikely to complain, due to the practical benefits outlined above. It was easy to include board members in the largesse as well. Most tempting was the fact that stock options were not recorded as expenses in the profit and loss statement when they were issued. Thus they were a cheap, if not quite "free" way to motivate managers, including the most senior personnel. When the options were exercised, their value was deducted from the shareholder's equity account in the balance sheet, as though they were unforeseen and extraordinary entries. Top management was able to receive huge increases in pay with no apparent cost to shareholders. They were almost like introducing a drug into corporate systems of incentives and controls; taking additional risks was a preferred route to a free "high." They were like steroids for the recipient while at the same time hidden from the shareholder who footed the cost.

How could stock options, an actual cost of doing business, not be recorded in the profit and loss accounts with other costs? The short answer is that the political system permitted it. Given the US political context described in detail above, a political system infiltrated by money companies lobbied with shareholder funds to increase their own pay. To explain: when the Financial Accounting Standards Board (FASB) studied this issue in the early 1990s, it concluded that all firms should be required to recognize options as an expense at the time when they were issued. However, this announcement was met with strong opposition from important segments of the business community and, as a consequence, from Congress. The accounting profession, for instance, voiced its objections quite loudly, using its lobbying power to prevent any political action against current stock-option accounting practices. Arthur Levitt, Chairman of the SEC from 1993 to 2001, explained the conflict in this way: "The integrity of the markets depends upon how high the FASB sets the bar and on how seriously the auditors take their gatekeeper role. Over the years, however, the standard setting process had failed to keep up with the games the companies play to make their numbers look better than they actually are. And auditing firms had grown reliant on the money they received from the consulting services to their audit clients. Whenever FASB tried to crack down by tightening accounting standards it ran into a phalanx of corporate, Congressional and auditor opposition."[104]

When Levitt took over the SEC, the FASB had decided to change the rules and require firms to record a charge for their grants of stock options. As he relates, "The FASB considered this deceptive accounting. And in June 1993 it voted unanimously to put out a rule . . . that would require companies to put a fair value on their stock-option grants and to record that number as an expense on their SEC-reported income statement. By the time I arrived that summer nearly all of corporate America was fighting that proposal."[105] Business interests and the accounting profession mobilized a lobbying campaign to persuade Congress to hold hearings and pressure the FASB to relent on its proposed standards. Silicon Valley was particularly concerned. Weak revenues at many small firms made cash compensation difficult; these firms argued that since options were not cash outlays, they should not be counted. "Hundreds of tech executives flew to Washington to lobby. The industry passed around alarming studies predicting that profits would decline along with economic growth," Levitt recounts. And given the susceptibility of US lawmakers to lobbying, they prevailed. According to Levitt, "even the Clinton Administration pressured the FASB to withdraw its rule."[106] In the end, as a practical matter, Levitt gave in, surmising that the FASB rule would not survive the political pressures and that business interests "would push to end the FASB role as a standard setter, [and] this would have been worse than going without the stock option rule."[107] Stock options thus remained off balance sheet until the mid-2000s, in the wake of the dot-com crash, which led to broad demands for reform.

In my opinion, the story of stock-option accounting illustrates how the notion of keeping markets free from public regulation invites remarkable distortions and

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[104]Arthur Levitt, *Take on the Street: How to Fight for Your Financial Future* (New York: Vintage Books, 2002), 114.

[105]Ibid., 115.

[106]Ibid., 116.

[107]Ibid., 117.

abuse. In fact, it is not far from the story told in Chap. 13, where business leaders by the end of the 19th century were using their wealth to prevent state and federal governments from effective regulation of their more tangible activities, such as labor relations or the discharges of pollutants into rivers and lakes. The government had never before set standards limiting their disposal of wastes into public waterways, let alone their hiring practices, and the *Lochner* case prohibited government from protecting workers against excessively long hours unless there were obvious problems of public health. The barriers to effective regulation were only broken once crisis came at the highest level, between the Supreme Court and President Franklin Roosevelt in 1937.

The Toxic Trio in a Nutshell

Laissez-faire capitalism emerged again in the 1980s, as the US economy was deregulated back toward its "free" state of the late 19th century, and it was not long before oligarchic results emerged along with it. Deregulation opened the way for abuse of the environment as well as consumers, and even the privatization of public employment, for example in the military, or protection of common resources. The higher the incentives for performance, the greater were the temptations to abuse the system. Deregulation, shareholder capitalism, and stock options formed a perfect, toxic trio to encourage abuse. Deregulation broadened the opportunities for abuse; shareholder capitalism provided the intellectual rationale for opportunism as a form of morality that favored corporate elites; and stock options exacerbated the problems, with huge incentives for the winners and little regard for the societal costs. Together, they became a toxic trio that, I believe, continues to reshape US business ethics toward far lower standards of behavior than we had in the 1950s, 1960s, and 1970s and perhaps lower than in the latter 19th century as well. US business schools were all too ready to follow suit, to show that their graduates were being placed in high-paying jobs such as financial services and consulting.

This toxic trio helped create a business culture quite out of step with much or even most of the rest of the world. This disconnect between stakeholder and shareholder capitalism seems not to be of much concern within the United States, where its uniqueness is not taken as evidence that the United States is out of step with the world but, rather, that the world is out of step with the United States.

Conclusions: Laissez-Faire Capitalism, Oligarchy, and the Subversion of Democracy

In the aftermath of the 1980 presidential election, US fiscal conservatives had reason to be delighted. President Reagan's victory was a mandate to retire socially democratic policies and return to a laissez-faire and even individualistic model of capitalism, one that decentralized more power to economic actors through its markets. In practice, the formal decentralization known as Reaganomics was extended through lax implementation by regulators who sometimes ignored even those liberalized regulations that remained on the books, for instance, those authorizing the Federal Reserve to regulate all mortgages in order to protect consumers.

While a number of other English-speaking countries embarked on similar strategies of deregulation at about the same time, the changes in the United States were the most radical because they were preceded by deregulation in the social and political systems, which were not found elsewhere to a remotely similar degree, and then followed with economic deregulation of both its labor and capital markets, as well as many product markets. Indeed, it can fairly be said that the United States was unusual in adopting deregulation as a panacea for its social, political, and economic woes.

With 30 years of hindsight it should be abundantly clear that the Reagan revolution did not tender a success in terms of proffering a superior model of economic growth. Average economic growth per capita in the 28 years since Reaganomics was adopted has not been faster than in the preceding 28 years. Economic instability, however, has been higher, thereby limiting the leverage that Americans could safely use in financing large purchases such as houses. Additionally, job opportunities for the median American have become more meager. Income inequality has increased, while median male incomes have stayed essentially where they were in the mid-1970s (as shown in Fig. 14.3). The growth that has occurred has been financed in an unsustainable way, more than doubling financial leverage in the US economy (as shown in Fig. 8 in the Epilogue).

What should one conclude from the US experiment with the renewed reliance on laissez-faire economics? In my view, the answer is that the revival of the laissez-faire model of deregulation was based upon deeply flawed logic. The model's intellectual foundation lay in the ideas of Milton Friedman, namely, that bilateral markets would be self-regulating so long as the economic actors were free to choose to transact with each other or not, and so long as they had roughly symmetrical information. Self-regulation as a framework for large-scale competition among business entities of varying sizes and powers with nonstandard products is, at a minimum, naïve. Arguably, it is a rationale for those with power to claim that the exercise of such abusive power is in the public interest which, like free stock options, is a scam. No large-scale organized competition can work without formal regulations backed by the coercive power of a political authority. To claim otherwise is to provide protective cover for those who would abuse such power.

The US embrace of what I have referred to as the Toxic Trio of the 1980s—laissez-faire regulatory standards, shareholder capitalism, and extreme forms of individualized incentive compensation—legitimized a near-exclusive focus on short-term results with little regard for longer-terms consequences, let alone responsibilities, and with little regard for those who did not have significant ownership in US equity capital, i.e., about 90% of the population. This helped alter the distribution of incomes in the United States to make it radically more unequal, indeed the most unequal among industrial countries. It also helped concentrate incomes among sectors, and the big winner was financial services. With about 6% of corporate personnel and 30% of corporate profits (as discussed in the Epilogue), this sector had secured the power to promote reforms that were to its advantage and to block those that were not. This new toxic model was accompanied by increased financial leverage in the system, which tended to increase the economic instability, including the increased level of bank failures. I have postponed consideration of these last two aspects of US performance for the Epilogue, when I look at the financial crisis of 2007 and beyond.

However, the most important message of this chapter is not that economic deregulation failed to promote higher growth, as Alan Greenspan and other market fundamentalists had assumed it would, or even that it was responsible for rapidly rising inequality, which it surely was. Instead, the most important conclusion is that the political and social reforms launched beginning in the mid-1960s thoroughly transformed US democracy as well as capitalism, and radically transformed US governance. The most important deregulations were social and political; they began in the 1960s and continued into the 1970s, and together they paved the way for the subsequent economic deregulation.

Paradoxically, the deregulation of US democracy in the name of making it more responsive *to* the people reduced the capacity of US legislators to govern the country *for* the people. Naïve attempts to open the US government to additional participation *by* the people had the effect of opening it to greatly increased influence by special interests.

The deregulation of the political system reduced the coordinating powers of government on the assumption that more inclusive and more transparent government was more democratic than more tightly controlled government. In so doing, it opened the gates for the subsequent distortion of market frameworks, as lobbyists picked off particular regulations piece by piece. Relaxation of the Glass-Steagall Act in the Clinton era was an early step; deregulation of the savings and loan industry a second; failure by the Federal Reserve to fulfill its legal mandate to regulate all mortgages to protect consumers a third. In the 1840s, as the previous chapter detailed, firms grew larger in the wake of the Industrial Revolution and eventually overpowered the regulatory powers of a government whose regulatory powers had been deliberately attenuated since its founding. It was a process that was only corrected following the 1937 confrontation between the President and the Supreme Court, when the legislative powers were returned to the Congress.

In the 1980s business was able to overpower government by a distinctly different process. Since the 1970s the powers of the federal government have been reduced, initially based upon the unintended consequences of the deregulatory agenda of the left, both in social and political reforms. In aiming to create a government that was more open, inclusive and transparent, they created one that was more open to external penetration and corruption by special interests. The federal government was still the towering power in the system, but the powers of government, and notably of its legislative branch, had become increasingly dissipated through deregulation and lobbying such that the powers of firms increased dramatically in relative terms. The capabilities of the federal government were dissipated through initially well intentioned but naïve reforms that were based upon the false notion that government which was more "open and accountable" was by definition more democratic. What was utterly missing was any notion that government by the people might not remotely be government for the people. Government for the people could be achieved and maintained only by institutions shaped so as to favor the broad interests of a middle class, as opposed to the narrow interests of special groups. In ignoring such fine points, the public supported regulatory reforms which allowed firms to transfer income from consumers and taxpayers to themselves, as when regulatory protections were suppressed or tax assessments abated (as in taxes withheld on foreign incomes which could be brought home at an amnesty rate of 5% instead of a more usual rate of 25–30%). In the absence of corporate charters that required a responsibility to society, firms prospered by value transfer (e.g., from taxpayers to shareholders).

The financial sector was a leading case, where progressively greater deregulation of financial services allowed the sector to add new and unregulated products, combined with higher levels of financial leverage, in such a way as to approximately double its share of corporate earnings between 1980 and 2007. In addition, it could market more and more tailor-made products that were frankly beyond the understanding of many if not most customers. Deregulation became a license for profiting from asymmetric information in formal terms, and from deceiving customers in more ordinary language. Could anyone say that these earnings were largely based upon adding value for society?

In contrast, the instability that accompanied increased financial leverage was a justification for still more unregulated, high-margin derivative products that could be protected from regulation by the very prosperity of the sector.[108] Deregulation was like a growth machine for the financial sector. Customers needed more and more protection against instability as the sector created a more and more unstable system. However, unregulated innovation was an assumed blessing. Was this any more true for financial services than unregulated new drugs would be an obvious blessing?

The rise in power of the financial sector was coupled with a weakening of the forces for democratic control of society. The number of lobbyists went up roughly tenfold, and political fundraising almost as much. Opening political primaries to unregulated electoral competition effectively required candidates to raise still more money to run successfully as a representative of a party's base before campaigning against someone from the opposing party. This put the extremes in both parties in quasi-gatekeeping roles and polarized parties, tending to favor candidates who were more extreme than their average voters. Polarization increased the need for money and the need for the support of organized interests. Members of Congress

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[108] See Paul A. Volcker, "Keynote Speech" (presented at the The Economic Club of New York, 395th Meeting, New York, April 8, 2008); Simon Johnson, "The Quiet Coup," *The Atlantic Monthly*, May 2009.

had to spend more time campaigning and more time in their districts. The congressional workweek was shortened. There was less time to get to know colleagues, less time to work out compromises, and much less of a political center to build out from in search of a majority. In addition, each member had been given new powers to act as a political entrepreneur, e.g., the right to introduce and amend legislation. Taken together, these changes made it harder to achieve negotiated or market-based legislative compromise. By far, the most important implication was that the social and political deregulation of the US political domain effectively, though unintentionally, paved the way for a decline in the capacity of US democracy to govern itself in an orderly fashion. Government became confrontational and erratic, as demonstrated by the use of government shutdowns as a coercive tactic of persuasion.

The broadcasting media were a notorious part of this change, as they had to have continuously renewed regulatory permits, any of which could be placed in doubt through a conflict with a sitting government. Meanwhile their powers of communication made them particularly important in primaries, where candidates were being introduced to the electorate. This was a political framework that was virtually unique to the United States, and of post-1970 vintage. Elected representatives to the most powerful legislative chamber in the world were themselves less powerful because they were so obviously beholden to special interests for the funds that they so desperately needed to stay in office.

Congress was increasingly the terrain of political entrepreneurs who were constantly trying to raise money for themselves, with the public's welfare anything but top priority. Whereas party leaders and committee chairs had traditionally been able to lead in the coalition-building processes, leadership and initiative were much more widely dispersed after the mid-1970s, and the market for Congressional legislation became more like all others, a market increasingly dominated by money, like an auction to be won by the highest bidder. Instead of coordination through seniority-based committee chairs like Wilbur Mills, coordination was much more democratic and objective, based on who could raise the most money. Firms in search of more favorable regulations could be expected to bid for better treatment. And the recent Supreme Court decision opened this gateway to still more flagrant abuse in the name of free speech for moneyed corporations. With more decentralization, it was harder and harder to build a coalition on any basis other than money.

Into the early 1970s, political authority had been hierarchical, vested in strong political parties, strong central government, a relatively modest business-government complex, relatively exclusive of its military–industrial component, and strong professional service organizations that played quasi-regulatory roles. The attacks launched against formal authorities in the struggles for civil rights and to limit or end the Vietnam War had the unintended consequence of legitimating wholesale attacks on authority wherever it was found. The system was transformed into one that favored stronger individual member interests, stronger electronic media grouped into fewer than a dozen firms, and more concerted and assertive business power, through lobbying as well as political contributions. Until the 1994 elections, power was much more decentralized in both Houses, and even coalition-building was more based upon confrontation. These conditions were an invitation to opportunism as a standard among elected representatives. And elected representatives would not be alone.

The relentless pressures on top managers to boost corporate profits so as to boost share prices and the value of stock options had a similar effect. Motivating managers to act like owners in such a context was very difficult to distinguish from encouraging them to act like pure opportunists. Thus, while on the surface these changes might be likened to a return to the laissez-faire model of the period 1890–1930, the differences were probably more important than the similarities. It was a subtle game where financial pressures were relentless. As knowledgeable insiders described it, "better people, worse system."

Sources of Power in the 19th and 20th Centuries

In the 19th-century United States, an oligarchy was created through the colossal growth of large firms in the new industries, as we saw in Chap. 13. Between 1830 and 1900, the largest US firms grew more than 1,000 times just in employment, and perhaps as much as 100,000 times in assets controlled. With the economics profession still focused on the familiar atomistic competition of the earlier era, there was little by way of theory to guide the regulatory processes, and would-be regulators could not keep up in the face of organized business opposition, backed by their platoons of lawyers, first at the state level and then nationally, particularly through the US Senate, which did not face popular electoral scrutiny. In addition, economic concentration, with its attendant powers of corruption, could be rationalized as an inevitable side effect of progress. To restrain the giants would curtail productivity growth based on increasing economies of scale. The fact that half the railroad mileage would be in bankruptcy in the 1880s was hard to relate to its causes, such as excess capacity from reckless overbuilding.

From the 1870s onward, these corporate interests were assisted by the assumed powers of the Supreme Court to overturn economic legislation that was inconsistent with the laissez-faire model. As a consequence, legislative bodies, state and federal, were stymied in their attempts to meet their popular mandates by enactment of remedial legislation, as in the *Lochner* case in New York State. A Supreme Court that subscribed to the idea that the laissez-faire model was ordained by the Constitution was able to overturn their work with a rising tide of decisions declaring such remedial legislation unconstitutional, as Justice Oliver Wendell Holmes pointed out in his *Lochner* dissent.

Once the policymaking role of the Court was bypassed in 1937, the role of the US economic oligarchy was reduced through successive regulatory steps which were then sustained, such as the passage of the Glass-Steagall Act (1933), which broke the large banks into specialized commercial and investment banks while prohibiting them from straying beyond their boundaries of specialization, a system that lasted into the early 1980s, only to be whittled away and finally repealed in 1999. By a similar token, Court decisions that had ruled labor unions as unlawful conspiracies in restraint of trade were replaced with legislation permitting collective bargaining, with protections for union members to try to organize employees in nonunion firms.

How Does One Correct a Weakened and Corrupt Democracy?

The oligarchic system that ruled the United States from the 1870s until the late 1930s was not toppled until the chaos of the Depression greatly reduced its power and a shift in the membership of the Supreme Court further curtailed it. No comparable upheaval has yet happened in the 21st century, though Simon Johnson suggests the need to overturn the oligarchy in our current circumstances, a possibility outlined in the Epilogue. In spite of postwar economic modernization, the built-in stabilizers in the economy, and the vast increase in real wealth, I think the problem of a weakened and corrupt democracy may turn out to be roughly as difficult to correct in the current US context as was its forerunner in the 1930s.

Profits in the 19th century came in substantial measure from real economies of scale and speed in vertically integrated firms, coupled with abuses of the market power permitted by lax regulation. In the post-1970 context, rising profits could come from the new technologies and new industries, repeating the process of value creation that was a benefit to society as well as the firms through which it was created. But value could also be extracted by firms from a very wealthy society through an increased subsidy, a reduced tax, or a Congressional earmark for a special project or firm. With more regulations, there were at least arguably more opportunities for profiting through manipulation of the system than through really increasing value for society. Lobbying had become a great growth occupation, even in a slow-growing economy.

Again our Toxic Trio of regulatory standards, shareholder capitalism, and incentive compensation plays an important role in the story. The use of incentive compensation to promote shareholder capitalism put tremendous temptations before corporate management to raise its earnings and share price and private wealth by gaming the system to get still more breaks from Congress. Transfers from taxpayers to shareholders were far easier to achieve than creating real value for society. The awarding of stock options to top managers based on share price performance was like adding steroids to the system. The improved performance for the firm bore no necessary connection to any improvement for society. The improvement could come from "premature" revenue recognition, "deferred recognition" of costs, accounting rules that allowed "extraordinary costs" to be charged directly to net worth, just like the previously "free stock options," without any charge to the profit and loss statement, and/or permission for pooling of interests to delay or avoid the need to write off excessive costs paid for acquisitions. Everyone was in the game and on the take; the accounting firms as well as the ordinary firms. Did the opportunism and corruption really matter, or were they simply like "luxury goods" in a very rich society?

At the beginning of this chapter, I quoted Fareed Zakaria's comparison of Woodrow Wilson's mission at the end of World War I—"to make the world safe for democracy"—and our current need—"to make democracy safe for the world." I believe—and will elaborate further in the next chapter of Conclusions—that our challenge is to make *American* democracy and capitalism safe for the world. US democracy, deregulated and transformed in the manner described in this chapter, has become a model of ineffective governance, and one with the potential to affect the world. Certainly, none of the other industrial democracies have made the changes that Zakaria has so presciently identified and analyzed.

Nor is US capitalism a safe model. Indeed, it is arguably no longer a model for any other country. Given its flawed theoretical foundations and "toxic" effects, the current deregulated US capitalism is no model for the United States itself to follow. It has induced greater economic instability and inequality, and an end to rising real incomes for those in the middle ranks, without any clear dividend in terms of more robust growth than its regulated predecessor. The vast expansion of public credit and public guarantees in the face of the financial meltdown suggest two results/outcomes: a covert move away from any sort of "free market" capitalism, albeit perhaps a necessary one, since collapse seemed inevitable without such government intervention; and a silent US repudiation of private-sector responsibility for results as the quid pro quo for the right to earn and keep the profits in a capitalist system, and notably in the financial sector. As in the 19th century, the private sector has overcome government to gain the right to profit without being held accountable for the results of its behavior.

However, the biggest shortcoming of contemporary US capitalism is not that the newly unleashed private sector failed to deliver the growth that had been promised; it is that laissez-faire capitalism, when paired with a deregulated political system, has allowed the business sector to increase its economic power to the point that it once again dominates government in the oligarchic model of the late 19th century. The US variety of capitalism is particularly problematic for a nation that, by virtue of its wealth and power, is inevitably expected to lead (and, itself, takes this leadership position for granted). Americans see their variety as a universal norm at a time when an increasing number of countries no longer share that view. Americans may experience some difficulty participating effectively in discussions of how to reform the system because they have little idea where their system came from, how or why it may differ from other systems, or why they should try to learn about any other system. Substantial reform to the US variety of capitalism seems necessary, but, as I discuss below, the prospects for such reform do not seem very promising.

Implications for Effective Reform of US Capitalism and Democracy

The most crucial reforms must originate in US democracy rather than capitalism, because unless the political system is reformed the US government will not have the power that it needs to curtail the oligarchic power grab that has been underway since the early 1980s. Structural changes and regulatory reforms are necessary to correct the damage done by the false panacea of social, political, and economic deregulation.

I will suggest four broad reforms that illustrate what needs to be done for the electorate to regain control of its democratic institutions. Two of these reforms lie within the political process; the third requires a change in the educational mandate of the public school system; the fourth necessitates changes in the capitalist system to reduce the proclivity of US capitalism to focus its power on promoting the interests of a very small elite. The most necessary reforms are: (1) changing the rules of campaign financing; (2) altering the nominating processes to reduce the dysfunctional role of extremists in both parties; (3) requiring public schools to educate their students in US history and/or social studies so that they will understand the electoral processes and how they connect to the practice of representative democracy; and (4) requiring firms to accept a much broader responsibility to society in return for their charters to operate in US markets. While I view these four reforms as essential to any long-run solution, I do not regard them as sufficient. By suggesting them in simplified form I aim to show what reform might look like, and just how formidable the barriers might be.

Campaign finance reform might be effected through something like the Canadian model. Canada prohibits campaign contributions from any entity except a natural person. No firms, unions, family trusts, or nonprofits may contribute; only bona fide individuals who are themselves eligible to vote. While this is established law in Canada, in the United States it would have to be enshrined in the Constitution to withstand the veto of the Supreme Court, where political contributions, no matter how unequal, are protected as a matter of free political speech. Thus, it would require a Constitutional Amendment, a huge barrier in the contemporary context. A precedent was set a century ago, in the progressive era, with the passing of the 17th Amendment, mandating direct election of US senators, thus relieving (corrupt) state legislatures from selecting senators. Any such legislation should also mandate public financing for elections, as is also the practice in Canada. Since Canada does not use open primaries to select candidates, public financing would be more complex here than there, but let us stipulate that a formula could be devised through the amendment process which would remove this matter of political process from legislation by the Supreme Court. There would be a cost to the taxpayer, of course, but any such cost would be trivial when compared to the waste that is generated through the policy distortions that are “bought” through the current political process.

As a way to break the distortionary effects of the extremists in the parties I suggest that the United States consider the Australian approach to voting, which is to require that everyone vote. In the US context, mandatory voting might have to apply to primaries as well as to final elections. In addition, it should probably be stipulated that only those registered in a party may vote in that party’s primary, to reduce the temptation to engineer crossover votes to derail a candidate in the primary of an opposing party. Penalties may be necessary, by individual or by state, for the failure to vote. Compulsion may sound undemocratic, but we consider taxes to be an obligation for citizen participation in a democracy; voting could be so considered as well. (I recognize that some Americans might protest being forced to vote without taxation.)

Third, an operational goal for education in US history and social studies would be to require that any such instruction explore the relationship between government by the people and government for the people or, worded a bit differently, that all students be exposed to teaching which explores the relationship between individual rights and the common good. The notion that a society can prosper while neglecting either of these two societal goals needs to be debated if Americans are to learn to govern themselves effectively in an era of mass marketing of all sorts of public policy nostrums.

Finally, US capitalism needs to be modified to recognize that the power of a corporation comes from society and not from the shareholders. Corporations must acknowledge these responsibilities explicitly. To do so would imply that it most certainly is not the mandate of the firm, nor of its senior managers, to use the powers conferred upon the firm to enrich a tiny few on the pretext that such behavior is in the interests of the shareholders, alleged to be the "principals." The principals who authorize charters are governments and ultimately legislators who act on behalf of society, and the behavior of firms should be expected to recognize that broader mandate. The United States can hardly expect better behavior from its business oligarchs unless it explicitly broadens their recognized responsibilities. To say that the mandate of the firm is to "make a difference," as some business schools have, is hardly a serious alternative sense of purpose. It is a vacuous alternative that simply allows directors and managers to act in their own self-interest.

Conclusions

Almost two decades ago I began a study of how relative incomes among countries had changed through time. Initially, I was seeking to explain why European societies had economically surpassed other countries after 1500, when their estimated income levels had not been much higher than other areas in the preceding century or two. Why had Europe pulled away from China, India, and Japan circa 1400–1800, a period referred to as the formative years of capitalism? While many factors contributed to income divergence—cultural differences, factor endowments, and geography among them—I was particularly impressed with the integral role of institutions in development, for better performance or worse, a point of view I share with numerous other researchers, including Stanley Engerman, the late Kenneth Sokoloff, and Douglass North.

However, as my research progressed, I became increasingly clear that institutions were neither created by natural forces nor selected by market forces; instead they were both forged and selected by human agency to be parts of a relatively small number of identifiable economic and political systems. Certain economic institutions are components of particular systems—for example, serfdom was part of a feudal system, freely mobile labor part of a capitalist system—to govern an economy. Similarly, certain political institutions are associated with particular political systems, for example, a limited monarchy, where the powers and obligations of the king are stipulated by law, or democracy, where the powers of a political leader are established through a legislature that is itself chosen by periodic elections.

Unfortunately, the literature of economic history tends to overlook governance let alone human intentionality. This lack of attention to human agency was for me the most conspicuous shortcoming of Fernand Braudel's three-volume history of *Civilization & Capitalism*.[1] He described broad patterns of development while ignoring the study of systematic differences in the institutions of various governance systems and/or countries as a way to explain why some societies or countries performed better than others, at least for particular periods of time.

[1]Fernand Braudel, *Civilization and Capitalism, 15th–18th Century*, trans. Siân Reynolds (New York: Harper & Row, 1982–1984).

B.R. Scott, *Capitalism*, DOI 10.1007/978-1-4614-1879-5,

In my view, examining the history of capitalism requires systematic attention to institutions and to the human purposes that they are designed to embody. Governance implies the power to control, design, and administer the institutions for ruling a system; these three functions imply the need for a visible hand with the capacity to make purposeful choices and to monitor progress and make corrective changes as needed, as well as the means to exercise power to create the desired institutions.

Governance, through a visible hand, should be contrasted with Adam Smith's famous metaphor of an invisible hand that automatically coordinates the actions of many actors without direct or purposeful intervention. Smith's invisible hand was, in effect, the pricing mechanism, and his insight was that this pricing mechanism had truly remarkable powers to coordinate economic actors via an indirect set of incentives, as embodied in prices. Coordination can be a powerful force, but it does not imply the intentionality of a system of governance. On the contrary, prices are permitted to change spontaneously in response to the uncoordinated actions of many parties; they bring order out of potential chaos without the need for purposeful governance. It was Smith's genius to see that no specific design was needed for such coordination. Smith's free markets could automatically promote a certain measure of improved performance through increased efficiency in the allocation of resources initiated by numerous otherwise uncoordinated actors.

However, the invisible hand cannot redesign the system in accordance with purposeful choices of a systemic nature, nor can it mobilize the power of a political authority to monitor performance or make corrective changes. It can only coordinate within the boundaries and relationships of an existing system. Governance, in contrast, implies the power to design and implement a set of incentives which give purposeful guidance to many actors so as to achieve a desired outcome. Governance can affect performance through planning, including an improved design of market frameworks that are continuously coordinated by the pricing mechanism. For example, one changes the market framework by adding a steep tax on the price of gasoline, which will likely reduce demand for gasoline to a new equilibrium level. It will also likely change the size and weight of autos and trucks.

The design of institutions not only opens the way for the creation of economic strategies, but also recognizes that the existing institutional arrangements already embody a strategy, no matter how implicit or shortsighted that strategy might be. Indeed, when capitalism is seen as intentional governance it implies that a strategy, emanating from political entities and not markets, is inescapable. The modernization of a capitalist system cannot be accomplished by economic actors alone; governance emanates from a legitimate political authority. Thus, capitalism as a system of governance is a good deal more complex than is supposed by those who would see capitalism as what firms do in markets. In the conclusions that follow, I will address foundational questions about the capitalist system before confronting some of the challenges facing capitalism as a system of governance today.

What Is Capitalism?

Capitalism Is a Social Construct, Not a Natural System

The most basic finding in this study is that capitalism is neither a one-level system comprised of economic markets nor a two-level system of those markets and their supporting institutions, but instead a three-level system of governance comprised of those two subsystems under the auspices of one political authority. As this declaration amounts to a restatement of the definition set forth in the introduction, calling it a finding risks the appearance of circular reasoning. Yet, in seeking to define capitalism, I have become increasingly aware of the overwhelming importance of defining the nature of capitalism as a system of governance, which functions quite differently from informal commerce at one extreme and a command economy at the other.

The basic argument on which this three-level definition of capitalism has been built is that capitalism is not a natural system; rather, it is a socially constructed system of governance for economic relationships among people and property. Of necessity it exists under the egis of a political authority with the power to create and maintain a set of institutions that, in turn, shape a set of markets in which economic relationships unfold. That political authority has the legitimacy to shape any and all markets, thus influencing the conditions in which the individual actors will achieve equilibrium through the price mechanism. Stated differently, capitalism does not arise spontaneously from a particular level of income per capita or any other particular set of environmental factors; nor does it naturally spread from one political jurisdiction to another the way a liquid might flow along a more or less level surface, as evidenced by the selective adoption of capitalism in the northern regions of the Western Hemisphere, and its absence in the Southern Hemisphere for another two centuries.

The Economic and Political Systems of Societal Governance Are Interdependent

The fundamental role that political authorities play in shaping the economic institutions that, in turn, shape markets causes capitalism to be inevitably linked to and intertwined with the political problem-solving system, which today is predominantly democracy. Thus, these two systems (i.e., capitalism and democracy) inevitably influence one another.[2] It is important to recognize, however, that they are built from partially conflicting first principles. Political scientist Robert Dahl compares these systems to "two persons bound in a tempestuous marriage that is riven by conflict and yet endures because neither partner wishes to separate from the other." Instead, they persist "in a kind of antagonistic symbiosis."[3] Capitalism

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[2] Almond. "Capitalism and Democracy," 467.

[3] Dahl, *On Democracy*, 166.

aims to utilize competition to unleash human energy and creativity while, at the same time, selecting institutional variants on the basis of superior performance, thus harnessing inequality for human welfare. Democracy, by contrast, is built from the moral principle that people are of equal human worth and therefore entitled to a measure of equality in treatment regardless of their relative economic performance. While these two systems can be harmonious in the creation of wealth, they can be contradictory when it comes to dividing the proceeds. Hence governance of any such system must bridge these contradictions while seeking to find common ground for the potential contributors.

Governance of the Economic System Must Be Exerted, at Least in Part, from the Top Down, Through the Political System

In a capitalist system, economic markets will only reflect society's true interests if enabled to do so through the political markets, in particular through the legitimacy of an elected coordinating device such as a legislature. But the capitalist system is likely to be nurturing inequality while democracy tries to moderate it in accordance with its moral basis. As Dahl writes: "the close association between democracy and market-capitalism conceals a paradox: a market-capitalist economy inevitably generates inequalities in the political resources to which different citizens have access."[4] Almost inevitably, tension persists between the two systems. It is a tension to be lived with and managed, as it cannot be eliminated without damaging one of the two underlying systems. This overall balance is maintained through a notion of appropriate governance, where those with economic power are held accountable to society for the permissible use of that power.

By changing the economic power structure, political actors can increase or decrease economic inequality. Through campaign donations and lobbying, economic actors can induce political actors to change the economic power structure and affect economic inequality. And indeed, the economic actors can try to subvert the political system for their own advantage just as the political actors can seek to extract "rents" from the economic system for their own private advantage. One cannot expect long-term stasis in such a context. Power relationships are almost bound to change along with external circumstances. For example, the United States enjoyed an almost unprecedented period of seeming symbiosis between its two systems circa 1630–1830, when each system was comprised of small, decentralized subunits.

The power to govern is also the power to corrupt or even to destroy. In order to govern effectively, the sovereign must have a monopoly on coercive power. Inevitably, this poses considerable risks because the sovereign can abuse that power. Economic transactions can and usually do take place in a context where the medium of exchange is paper money whose supply can be increased by actions of one or

[4] Ibid., 158.

more political authorities, either directly by authorizing additional currency or indirectly by permitting additional leverage on existing capital. By increasing money supply, or refusing to do so, the political level inevitably influences the level of economic activity through the intermediation of institutions, and in this case the money supply. Control of the money supply opens the system to the possibility of flagrant abuse, such as inflating the currency in order to finance development or projects to favor particular political groups. Taxation and expenditures create similar risks of abuse. Thus government is inevitably implicated in economic development, and more than many people are wont to recognize.

Governance Can Affect the Mobilization of Resources as Well as Their Allocation

The prevailing theory of capitalism has focused almost exclusively on the allocation of resources, assuming that the level of resource mobilization is more or less fixed in any short-term period. Keynesian economics, where government could boost demand through deficit spending, was shoved aside by free-market fundamentalists beginning in the 1980s. A richer theory of capitalism recognizes that societies can mobilize more or fewer resources as an expression of political will. Political authorities can and do influence the rate of mobilization of resources, for example, through regulations requiring higher down payments on homes as a way to "force" saving, or prohibition of consumer credit for a similar purpose. On the other hand, the authorities can tilt in the opposite direction to subsidize borrowing, thereby reducing net resource mobilization through a "buy now, pay later" strategy. Thus, the ultimate discipline of capitalist markets is dependent to a considerable degree upon the sense of responsibility of the political authorities who print currencies, subsidize saving or consumption, and set the rules for acceptable financial leverage. The humble consumers who exercise their "sovereignty" in making choices at the fruit and vegetable stand or other retail markets play a visible and symbolic role, but one that is decidedly subordinate in capitalist development.

Political authorities—responsible or otherwise—also influence the distribution of economic resources by directly influencing economic institutions. Social or political institutions such as slavery or serfdom can neither emerge nor be extinguished by the economic actors; they can achieve increased influence or fall into disuse as market conditions evolve, but the authorizing and extinguishing of the institutions of capitalism lies in the political realm and not economic markets, as is clear in Chaps. 8 and 9. Tolerance for patron–client relations is a political choice, and so is tolerance for segregated markets in employment, education, and housing. In like manner, the institutions of collective bargaining, a minimum wage, and even the notion of limiting the charge for loss or misuse of a credit card, cannot be readily created by the economic actors. Creation, modification, and eventual prohibition of many institutions of capitalism must come through the political system; some of these changes may imply modification of the political system itself, giving an advantage to one party or interest group. All of these institutions influence the distribution of both resources and opportunities.

Capitalism and Democracy Are Neither Neutral Nor Static Systems

Each variant of capitalism implies a strategy for greater or lesser mobilization of resources, and also for their allocation across space and time. In democratic societies these strategies are legitimate subjects of political contestation among the various subunits of what Dahl has called a polyarchy of power centers. There are multiple subsystems of governance within any capitalist system, including levels of political authority as well as private systems of governance. In the United States, for example, in addition to the governing capabilities of the executive and legislative branches, there are subsidiary levels of governance, down to states, counties, cities, and even gated residential communities.

At the same time, the economic system has an impersonal, undirected coordinating system—though not a governance system—in its markets.[5] Powerful, private governance systems, right at the core of the capitalist system, coordinate the product flows of firms, as Alfred Chandler argued in his explanation of the role of "the visible hand of management." Firms themselves have governance systems where shareholders have nominal rights to expect certain behaviors from boards of directors, while the latter also try to influence management. These governance systems, private as well as public, have their idiosyncrasies and imperfections; however, none are mechanical systems, and all can work to affect the existing power structure, thereby increasing or decreasing inequalities.

Capitalism Can Challenge the Power of a Political Authority as Well as Enhance It

As Chaps. 13 and 14 have shown, the United States has experienced dramatic increases in economic inequality over long periods, first after 1840 and then again since 1980, while the distribution of incomes within European countries has been much more stable than in the United States since 1980. In the former case, that of the United States in the 1840s, tilting a capitalist system to favor capital was both a political and an economic act. But in the later case, it was the reduction of the powers of government in the 1970s that laid the groundwork for a resurgence of oligarchy and thus a sharp rise in inequality. As capitalism tends to produce economic

[5]Coordination through economic markets is shaped by the different governing bodies, but they have distinctly limited capacities for self-correction, especially when it comes to recognizing the large macroeconomic imbalances that can arise from inadequately regulated bilateral transactions. Thus, as I pointed out in the previous chapter, bilateral mortgage transactions can add up to huge macroeconomic imbalances, a fact that inadequately regulated mortgage markets cannot correct.

inequalities in the absence of continuous monitoring and conscious intervention, one needs to consider how such increases occurred, i.e., to what extent they were attributable to policy choices.

Capitalism may imply oligarchy, but it does not *require* it. Certainly, it is particularly likely to generate rising inequalities when large or powerful firms have no corresponding obligation to society for how they use their power. Economic inequalities can be held in check or even reduced by deliberate adjustment of institutions. The political system of democracy, in particular, can moderate and perhaps even eradicate the tendencies of capitalism to produce rising inequality, for example, through provision of social insurance, a minimum wage, a progressive income tax, a strong educational system, and effective law enforcement. How these policy goals can be achieved without dulling the incentive structure of society is a much more subtle question, and one beyond the scope of this book. On the other hand, democracy—or any other political system of governance—can also shape the economic system in ways that encourage inequalities.

Changes in the institutions of capitalism can lead to important changes in the power structure of a society. Such societal change occurred, for example, when the rights of collective bargaining were authorized and protected in the 1930s by a number of industrial democracies, as advocated by labor unions and the political left, thus helping to reduce economic insecurities and inequalities. In time, these changes had a major impact on the distribution of income between capital and labor, clearly increasing the share for labor. Alternately, after World War II, European labor unions, seeking to induce more rapid investment, underutilized their bargaining power to permit capital to have a higher share of the income, often holding wages to less than 50% of GDP compared to amounts in the 60–70% range from the 1970s onward. Institutional changes can authorize the awarding of stock options or omit them from the profit and loss accounts, thus inducing additional risk-taking or greatly increasing the inequalities of income, in the name of increasing the incentives to produce. As Chap. 14 discusses, these changes have recently occurred as part of the political agenda in the United States.

Economic actors are not the only participants who might potentially abuse the system; political actors can and will do so if given the chance. Therefore capitalism requires a way to hold any such political authority accountable to the public that it serves. This form of accountability must be achieved through the political system (i.e., through elections as well as alternate, balancing branches of government) and assisted by a free press with the resources to do investigative reporting and withstand political pressures favoring silence. But, again, the first line of defense should be to correct the incentives, thereby reducing the likelihood of the opportunistic behavior.

Viewing the markets of capitalism through the lens of a simple one-level model of bilateral trading relationships focuses on relationships between supply and demand without telling us much about how markets affect or are affected by power relationships in society. In practice, most economic transactions take place among persons of unequal power with unequal access to information, such that so-called free markets are typically characterized by different degrees and forms of coercion.

Capitalists Cannot Govern Themselves Absent an Imposed System of Regulations

Capitalism depends upon laws, regulations, and many other institutions, and it relies upon the state to adjudicate differences among the parties in their interpretation, and subsequently on their enforcement by the administrative agents of the state. Thus, governments must play a far more instrumental role in capitalism than Adam Smith implied when he said that what was needed from government was peace, easy taxes, and tolerable administration of justice. The institutions that underpin markets, such as a currency that serves as legal tender, or deposit insurance for banks, or a bankruptcy code for businesses and individuals, do far more than just provide the boundary conditions in which competition takes place, as if on a level playing field.

Capitalism has sometimes been misunderstood as an economic system that has been created and operated independent of government through economic markets, or, in short, as a self-regulating system of voluntary transactions. This argument does not withstand scrutiny either in terms of history or logic.

While the notion that markets can spontaneously coordinate supply and demand in a way that approximates optimal solutions for society as well as the participants was a remarkable insight 200 years ago, and remains partially true today, this characterization of capitalism is incomplete for three basic reasons. First, there are no property rights absent law, and no laws absent a political authority. While trade can flourish informally, laws and the judicial powers of government are necessary to settle any disputes over the nature of transactions. Second, markets can achieve equilibria that are far removed from social optimality if serious negative externalities exist, such as the uncounted costs of pollution. Market equilibria do not automatically imply—or even suggest—socially optimal outcomes. Third, markets cannot correct these externalities by themselves. It takes a political authority and the mobilization of political power to effect the change. Individual transactions can be self-governing in some situations, but these situations do not remotely add up to a system that can do likewise. Home mortgages may be scrutinized by lenders and borrowers, but none of these lenders or borrowers has aggregate responsibility in the event of a property bubble brought on by excessive not to say reckless lending matched by irresponsible borrowing.

Equilibrium Is Not Governance

The study of how markets reach equilibrium focuses on the behavior of economic actors in a given institutional context and thus on only one level of a three-level system. While correctly recognizing that economic actors can be coordinated automatically through the price mechanism, it largely ignores the role of a set of institutions which shape the various markets toward different societal priorities (level 2) as well as the necessary role of a political authority responsible for the creation, enforcement, and periodic modernization of those institutions (level 3). Equilibrium in a distorted set of institutions seems to be a tempting subject for mathematical modeling, but that modeling does not necessarily reveal optimal outcomes for society. In order to equate individual and societal costs and benefits, the institutions must be properly designed and effectively implemented through an appropriate set of regulations, which must be shaped by a political authority and cannot normally be effected by the economic actors themselves. Therefore the study of capitalism requires a framework that encompasses political economy and not just economics.

While defining capitalism as a self-governing system of economic markets appears rational and scientific, its application as the basis for a theory of social behavior represents a form of ideological fundamentalism and intellectual imperialism where all forms of learning about human behavior can be reduced to propositions from economics. The self-governing view of capitalism is particularly weak when we move from the product markets to the factor markets. The institutional frameworks of factor markets in land, labor, and capital are even more deeply embedded in the structures of society than the product markets, as Karl Polanyi and E. L. Jones have pointed out.[6] A market for labor implies the freedom to change jobs or to relocate for better opportunities, both of which, in turn, imply an end to involuntary servitude and the existence of certain personal freedoms under the protection of political authorities. Markets for land imply an end to entailment and primogeniture. And capital markets require the recognition of interest as a legitimate form of return as well as the potential to establish legal vehicles through which varying amounts of capital can be mobilized and carried forward through time, such as through a partnership, corporation, or trust.

While capital markets are an essential feature of capitalism, they allow for great concentrations of power in private or public hands. They may permit the creation of certain institutionalized protections for investors (e.g., grants of limited liability for shareholders), just as they may permit firms to lock up shareholder capital for an indefinite term, subject to the approval of the directors of the firm, and thus create potentially great centers of economic power. In past eras, societies could and often did restrict or even deny to private parties the right to use legal vehicles to mobilize power, for instance, through corporations, regarding them as potential threats to the power of the sovereign. Permitting such concentrations of power in private hands was most likely to be found where the sovereign was concerned about foreign threats, such as takeovers.

Capitalism Is Based upon Indirect Governance and Not "Free Markets"

The markets of capitalism are quite marvelous institutions which embody an indirect form of governance. That is to say the economic actors of capitalism are free to develop new products and production processes and new markets and to trade with

[6]See Jones, *The European Miracle*; Polyani, *The Great Transformation*.

one another in a competitive context so long as they obey the rules of their particular capitalist system. Whereas the *markets* of capitalism are typically described as "free markets," the *freedoms* of economic actors in those markets are always conditional upon their obedience to a set of laws and regulations. Truly free and unregulated markets are not a recipe for organized capitalism; instead they are a recipe for instability and even chaos, as the recent global financial crisis has demonstrated.

While free trade is important to the performance of capitalism, its importance is sometimes exaggerated, particularly in English-speaking countries and in their universities. Free trade by itself is not an adequate force to spread the institutions of capitalism nor to promote economic development. It is simplistic to think about effective development absent the development of human resources and the use of human intellectual capital to design market frameworks to meet various social objectives. Economic development is facilitated by stable families, widespread access to public education, and effective enforcement of laws designed to protect the people—all of them. The examples drawn from the US South and Italy's Mezzogiorno (Chaps. 8 and 9) make the limitations of the free trade remedy abundantly clear; free trade was compatible with racial segregation in the US South and with patron–client intimidation in the Mezzogiorno.

The Three Levels of Capitalism

My definition of capitalism as a three-level system of governance is at one and the same time a research finding based on a limited number of case studies and a model of how capitalism can be expected to work in any situation, including how capitalist systems may vary from one another. It is a dynamic model, consisting of product markets and factor markets, all embedded in institutions governed by a political authority that is shared with another governance system, to wit democracy, as explained in theory in Chaps. 2–4, and in practice in the subsequent historical chapters. The theory indicates how the authorities of political governance can modify institutions and thus capitalist relationships through purposeful intervention. While surely not a complete model, it is arguably an improvement upon its predecessors, i.e., the purely descriptive (or zero-level) model of Fernand Braudel, the one-level model illustrated by Classical Legal Thought in Chap. 13 and subsequently by the work of Milton Friedman in Chap. 14, and the two-level model pioneered much more recently by Douglass North.

In the 1960s, Braudel recognized that capitalism was a system but did not identify it as a system of governance, let alone specify its component parts or its operating principles. As a result, he was left with the idea that the "yeast" that led to the rise of Europe lay in its cities, with their roads, walls, market stalls, and more advanced specialization of labor, and not in the advent of a capitalist system of governance that had been created and operated by human agents in those cities. Milton Friedman offered an operational model of capitalism based on a stylized single-level conception occupied by self-regulating economic relationships, wherein consenting adults automatically adjust their behavior appropriately to suit market conditions to effect mutually agreeable transactions.[7] Overlooking the inevitability of unequal power relationships, Friedman insists that if participants are free and adequately informed, they can achieve coordination and this coordination will be optimal for society, as Smith had suggested over a century earlier. But a series of bilateral transactions only add up to an optimal solution if all of the relevant macro costs are recognized, and if the power relationships are considered acceptable, which cannot be taken for granted once the power of oligarchy emerges, or alternatively the weaknesses of an underclass.

The crucial importance of the power relationships in the functioning of capitalism was underemphasized if not altogether omitted by Smith, as for all practical purposes it could have been even in the time of de Tocqueville. However, such omissions become naïve upon the emergence of the new industries of the Industrial Revolution, with their power-driven machinery and increasing economies of scale. "Equilibrium" in such cases is a dubious concept, as the cost curve does not ordinarily turn upward and the more efficient firm can drive all others out of business. If an uneasy equilibrium can be maintained in an oligopolistic situation, it is because a monopoly will be met by a forced breakup of the leader by an antitrust authority, as happened in the United States in a few cases beginning around 1900 (e.g., in the case of incipient monopoly proposed by Northern Securities or an actual monopoly created by Standard Oil).

Douglass North improved greatly on Friedman's narrow definition of capitalism by adding a second level, that of institutions.[8] Unlike Friedman, North recognizes the role of institutions in defining and developing economic markets. According to North, economic development requires the modernization of the institutions of capitalism just as much as the achievement of equilibrium in economic markets. Lacking a second-level perspective, neoclassical economics never was an adequate framework for the study of economic development. However, North stops short of explaining where institutions come from, how they are designed and/or modernized, or how they may embody conscious purpose, as in a strategy. The analysis of capitalist systems thus requires recognizing yet another level beyond the first two of markets and institutions.

Throughout the past 14 chapters of theory and cases, I have striven to add this third level, building on North just as he has built on Friedman and others, in order to offer a more complete model of capitalism for our contemporary context. A political authority must be involved and, moreover, it must have the legitimacy to govern the economic system, the political power to periodically reshape and/or modernize its institutions, and the coercive power to see that its decisions are implemented. I conceive of a capitalist system as one where the ultimate powers of governance of the system flow from the third level of political authority, through the second level of institutions, to finally affect the primary level of markets. Capitalism in this perspective is an indirect system of governance, which is a central tenet of this book.

[7] See Friedman, *Capitalism and Freedom*.

[8] See, for example, North, *Institutions, Institutional Change, and Economic Performance*.

Whereas firms are independent actors in neoclassical economics, they are dependent actors in this perspective of capitalism. They do indeed have certain established freedoms, but all such freedoms are conditional on obedience to the rules embedded in the system.

Political authority is not the only source of governance in the system. Firms are quasi-independent sources of power and governance as well, and they can attempt to influence the political authority in their favor. Their power and influence has been inadequately recognized in this book in order to focus on a less well-recognized system of power. In Chaps. 13 and 14, however, I focused on corporate power and its potential to corrupt the system. When firms or families command a great deal of power, it is appropriate to speak of oligarchy rather than real democracy. Power flows up through the system as well as down, and some measure of corruption is the rule rather than the exception.

The key difference between my conception of capitalism and others', North's included, lies in my emphasis on the power of institutions to shape the system at the insistence of human agency rather than through impersonal market forces. Whereas the invisible hand of the pricing mechanism automatically coordinates supply and demand within economic markets, it is human agency, acting through competitive processes in political markets, that mobilizes political power to shape the institutional frameworks in which all economic relationships are embedded. Seeing capitalism from Friedman's one-dimensional perspective overemphasizes the role of the trading system; private parties enter, transact within, and exit markets while the price mechanism balances supply and demand. Some of these trading relationships may seem voluntary and based upon adequate information, and the element of coercion may not be great. But it is much harder to overlook imbalances of power in the factor markets, and thus the continuous presence of implied coercion.

My conception of capitalism emphasizes its dual role as a system of production as well as trade.[9] Labor may be able to coerce capital in some circumstances, particularly if industry-wide bargaining is permitted for unions and not for management, and slack labor markets give management more power over labor. But more often it is capital that can coerce labor, and indeed this imbalance is continually augmented by globalization, because capital enjoys far greater mobility than labor. Labor becomes more and more the dependent actor that can be abused as the world economy globalizes.

Seeing capitalism from a three-dimensional perspective, where the institutions of bargaining and law enforcement are included, expands it to a more sophisticated production and distribution system. The need for governance by an accountable political authority then rounds out the scene. Private parties may mobilize resources and exploit new technologies in search of profits (such as through licensing agreements), and they may seek the assistance of a political authority to gain added advantages; shareholders can escape losses through limited liability; and employers

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[9] I share this perspective with Erik Reinert. See Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor*.

can use implicit coercion to induce employee efficiency. The mobilization of a higher fraction of total resources relative to GDP is a key aspect of high-growth strategies. All three levels of capitalism must be recognized in order to understand capitalism as a system that has the capacity to induce gains from research, development, and production as well as distribution and trade.

A final difference, with several implications, is that my conception of capitalism allows for the reality of different varieties of capitalism. Government actors (level 3) shape the institutions (level 2) of both the distribution and production systems in order to mobilize and allocate societal resources in the markets (level 1). These choices are subject to the overall political agenda or strategy of the political actors, often influenced by voter monitoring and periodic approval. Accordingly, the choices vary greatly from country to country, if not from election to election. Capitalism thus comes in different varieties in different countries run by different parties with different agendas and different voter preferences and power. In this perspective, countries become partially competitive actors. The traditional neoclassical notion that countries do not compete is simply naïve in a context where countries can and necessarily do have economic strategies. Failure to recognize this reality may turn out to be very costly to the countries that continue to pursue one-level systems of governance while others see how to mobilize resources in a three-level perspective.

Why Capitalism?

The Historical Origins of Capitalism

From a historical viewpoint, capitalism was a dynamic successor system to feudalism in most cases, and a successor to centrally planned economies in a few. As discussed in Chap. 5, it emerged first in Europe, without much of a guiding theory, as a set of institutions that helped various competing political entities in their efforts to facilitate rising incomes and increased borrowing power to finance their regimes. Higher incomes helped a society improve its standard of living and increased borrowing power helped it afford to hire more troops in the event of an emergency. The rule of law underpinned both increased productivity of capitalism and increased credibility when a society needed to borrow money.

Capitalism was created inductively by a small number of political competitors from among a population of more than three hundred political entities in Western Europe circa 1400. This process is often dated as beginning in the 15th century, but it seems clear to me that it began even earlier, in Venice and in a few quasi-independent cities. The successful examples were created in different ways, and at different times, over the next 400 years, as the number of competitors was whittled down to about 40 by the settlement of the Napoleonic Wars in 1820.

To say that capitalism was created inductively is not to say that it was created spontaneously from the bottom-up. Since capitalism, as I have defined it, had factor markets as its defining component, my reading of the evidence is that capitalism was created "top down" in these typically small entities. The critical decisions were by political leaders who authorized potential entrepreneurs to exercise power as a way to help raise incomes for themselves and their communities, where these higher incomes could subsequently be taxed to provide for defense and other public goods. At other times these factor markets arose as a result of a coup or hostile takeover. In this perspective, Venice, the Netherlands, England, and the United States deserve to be considered among the earliest capitalist regimes to survive for at least a century, and probably in that order.

When capitalism is defined to include factor markets as well as those for goods and services, it clearly did not exist before the time of Christ. Nor did it exist in Mexico prior to the advent of the Spanish Conquest, or indeed for 300 years after that Conquest. Nor is capitalism a system that emerged spontaneously in many parts of the globe, and then evolved on the basis of competitive selection and survival of the fittest. Rather, it is a socially constructed system of governance for economic affairs that was created in particular times and places, initially in Europe, and was usually transferred from one society to another by political upheaval. Indeed, capitalism would seem to deserve a place alongside limited monarchy, with government based upon the rule of law, and the Enlightenment, where human reason was recognized as the ultimate source of authority rather than ancient texts, as the third of the great European social innovations.

Britain was an early leader in creating markets for land and labor, but not through a spontaneous process with full public support. On the contrary it was primarily through a process of enclosure authorized by Acts of Parliament that often entailed the use of coercion to dispossess small farmers from their land. As Karl Polanyi describes—and as I note in Chap. 5—the rural aristocracy used Acts of Parliament to take pieces of common land as the basis for enclosure by a single owner in a process that boosted the productivity of capital while "freeing up" labor.[10] A Parliament responsible to less than 2% of the population employed official coercion to dispossess farmers of their means of earning a living in a process beginning as early as the 15th century and continuing for more than 300 years. Typically, the crown tried to slow this process to reduce social tensions.

Acemoglu, Johnson, Cantoni, and Robinson describe a very different process in France, where the French Revolution spelled a brutal and rapid end to feudalism, based upon the elimination of the crown and the nobility, which was followed by a succession of authoritarian regimes.[11] Furthermore, French troops brought an end to feudalism in much of Germany and in other parts of Europe within a few years early in the 19th century. While some of the new regimes fell with the overthrow of Napoleon, others remained to continue their own processes of institutional development.

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[10] See Polyani, *The Great Transformation*.

[11] See Acemoglu et al., "From Ancien Régime to Capitalism: The French Revolution as a Natural Experiment."

The Geographic Origins and Evolution of Capitalism

If my understanding of capitalism proves useful, future researchers may wish to review the available records to try to establish the times and places for some of the key institutional innovations that have been the essential building blocks for the system, and thence to date its origins and/or spread, society by society. Among those key building blocks are the emergence of factor markets for land, labor, and financial capital, and an adequate confidence in the rule of law to make formal transactions the basis of commerce. The creation of double entry accounting and the adoption of paper money and the institutions of fractional reserve banking were also crucial innovations. Informal commerce, such as barter conducted according to local norms and customs, does not qualify as capitalism any more than informal football in an unmarked field without independent referees constitutes organized sport.

Even with such a crude definition, I think the records are sufficiently clear to indicate that capitalism originated in Europe and that it predated another of the great European innovations, i.e., the Enlightenment, or the notion that the ultimate source of authority in human affairs should be human reason. Venice would be an important illustration, with its capitalism dating from perhaps 1300, some 300–400 years before the Enlightenment and perhaps 200 years prior to any other durable capitalist system.

The Earliest Capitalist System: Venice

Based on my definition of capitalism, and on my search of the literature, I believe that Venice deserves recognition as the first example of capitalism that survived at least a century. The Venetians seem to have created capitalism somewhat before 1300, and thus centuries before anything similar in China, India, Japan, Mexico, Peru, or the United States. They were ahead of other areas in Europe as well, but any attempts at more detailed reckoning would benefit from a careful search of the historical sources with this new definition in mind.

The Venetian case is easy to make. In 1300 Venice was a small entity, based upon a voluntary federation of islands in the Adriatic, and governed by an elected duke who served for life. However, this governance structure was built upon an utterly exceptional set of geographic circumstances consisting of seven small islands with meager resources other than some salt deposits, all of which were acutely vulnerable to attack by sea. Unlike some of the other Italian city-states, the political structure of Venice was initially built from a voluntary association premised upon limited government and the rule of law. This structure was a foundation for stability for about 1,000 years; its economic policies provided the revenues to finance its defenses.

The seven Venetian islands were able to sustain an independent political entity through military preparedness and a diplomatic service, both of which required a cash-generating economy to support its administration and its defenses; additionally, a federation for confronting the islands' security risks was needed. Venice created a managed trading system, taxing its trade to finance, among other things, an "Arsenale," which was for a time the world's largest factory; it built both naval and commercial shipping vessels. By 1300 Venice had become the richest locale in the world, but emphatically not on the basis of either democracy or free trade.

Both Florence and Genoa had brief stints as self-governing entities with very successful capitalist systems, but their governments were overthrown, by domestic upheaval in the case of Florence and by a stronger neighbor in the case of Genoa. There were also early entries in southern Germany and at Antwerp. None reached the combination of scale to defend themselves from external threats and a structure built upon consent to protect them from internal upheaval. Venice provided a truly exceptional set of circumstances, settled by people who could appreciate and develop its potential as a mercantilist city-empire based upon societal constructs that were centuries ahead of those in nearby "Italian" areas.

Why Europe?

After Venice, the European region as a whole was the next area in which capitalism began to slowly emerge. Europe had many elements of a common culture, including Roman Catholicism and Latin as a language of learning, plus vestiges of Roman law that survived the fall of the empire. Europe had a number of potential capitalist systems that did not survive; yet it had multiple successes over time and notably in the period 1400–1820. Why would capitalism bubble up and flourish in Europe?

My answer, stated briefly, is as follows. Just as the Venetian city-state faced pressures to defend itself from external attack, some 300–500 European political entities, mostly very small, faced nearly continuous political competition from their own numbers from 1500 to 1800. Though this competition was mostly among themselves, most of the European entities also faced potential invasion by the Turks. In that competitive struggle, nearly 90% of the political units lost their independence; the hundreds of entities were reduced to 40. Those that did survive the fighting did so because they had adequate forces at their disposal, which, in an era before conscription, required capital with which to finance mostly mercenary forces. Smaller European states, such as Venice, needed to find additional resources to finance their defense against the larger states, or to achieve something similar through a dependable alliance.

To raise the necessary funds, European rulers, on the whole, could not impose large levies upon their aristocracies, as doing so might require giving up essential political support in return. Instead, they turned to much more modest levies on their nascent entrepreneurial classes. Recurring revenue needs induced the various rulers to open up opportunities for their city dwellers or bourgeoisie to undertake new activities to create additional incomes, which could, in turn, generate increased tax revenues. Quite simply, the need for cash incomes for defense created great pressures to end feudalism; capital had to be free to flow to new businesses, and laborers had to be free to move to places of greater economic opportunity, in order to earn greater taxable income, as explained in Chap. 5. Eventually, institutions were developed to facilitate such revenue-producing activities, such as bills of exchange to permit long distance trade, and central banks to permit the mobilization of savings and the financing of public credit. Central banks could borrow on the signature of parliaments, and thus at much lower rates than banks that relied upon the signature of a king alone, e.g., 3% versus 11–15%. These differences in borrowing costs allowed the mobilization of much larger armies by smaller countries. Once established, a central bank could also provide the basis for a system of domestic credit that was far more elastic than one based on specie alone. As European rulers liberated their factor markets, permitting residents the freedom to earn incomes that could be taxed to finance defensive military ventures, they also brought down the cost of financial capital and established the legitimacy of interest payments, thus increasing the potential for capitalist development.

As noted throughout this book, and particularly in Chap. 2, free factor markets seem to be the defining characteristic of capitalism; but just when they were freed—and above all how and why—deserves more research. Capital markets facilitated investment by making financial capital more widely available, but they also helped develop the logic of capitalism, which was to allow capital to flow freely according to where investments would yield the highest returns rather than where ruling classes (e.g., the monarchy, the clergy, or the elite) would rather dispose of them (e.g., for personal purchases, church embellishments, etc.).

Once established, the factor markets remained relatively free and dependable, because no single power was able to dominate Europe and thus to confiscate the funds of the merchant classes. This freedom was sustained by political actors, and notably by a balance of power maintained in Europe for centuries by English policy, backed by their navy. The English ensured that no competitor would become strong enough to dominate the rest and, in effect, functioned as an antitrust agency.

Why Only Europe?

Why did this process of political struggle and defensive fundraising, with institutional innovation to support the latter, take place only in Europe at the time, and then mostly in certain parts of Europe but not the whole of it?

I take the second question first. It is important here to note that I do not mean to suggest that all European countries followed the pattern of responding to external military pressure by raising capital through freer factor markets. Not all European rulers responded similarly to the new balance of power. Those rulers with absolute, monarchical power over big countries felt less pressure to cede political power to their wealthier classes or to in any way legitimize the raising of capital for defensive purposes. France and Spain were the two great powers of the era, and both had absolutist regimes with rulers who refused to accept central banks as managers of their funds. In such circumstances interest rates remained high, capital markets remained stunted, and commerce was slower to develop. Absolutist regimes lost out over time to more modestly sized regimes in England and the Netherlands, which had to abide by the rule of law to minimize borrowing costs in order to be able to raise substantial armies on short notice.

The countries in which capitalism took root early were middle-sized powers characterized by limited monarchy, notably Venice, the Netherlands, and England. These smaller countries had to free up their capital markets in order to better raise funds for military purposes, developing institutions such as a central bank that gave their governments the credibility to borrow money at about 1/3 the interest cost of France and Spain. In the long run, this facilitated the development of capitalism in these countries. The Netherlands, with about one million inhabitants, was able to fight England and Spain at the same time, thanks to its extraordinary financial power, though this power was dissipated through a series of wars.

This same reasoning extends to the first and broader question. Unlike Europe, many other geographical areas, such as China, India, Japan, and the Ottoman Empire, were ruled by a single power. In general, these larger nations/empires experienced less threat from outside, had sufficient military strength for their own defense, and could impose harsh and even confiscatory taxes in lieu of freeing up their markets for commerce and thus greater taxation in time of emergency. Outside of Europe, rich factor endowments compelled the ruler to levy extraordinary taxes without the consent of a legislature. The great Gangetic Plain in India was such a case; a Muslim regime could simply increase the oppression of its Hindu subjects.

Thus, the necessary conditions for early capitalist success seem to include (1) limited monarchy or rule of law combined with (2) considerable existential challenges, and (3) relatively scarce factor endowments. The only exception seems to be the United States, where rich soil in parts of the South led to slave-based, plantation agriculture, but without ever involving a majority of the population. North of the Chesapeake the colonies had less rich soil, and the need to create effective institutions to avoid out-migration. After the American Revolution, the Atlantic Ocean and the British Navy provided protection against foreign takeover.

Contrast these experiences with the societies of Central and South America, which were settled by Europeans and which had at least a 100-year head start on North America in terms of European colonization. My reading of the evidence is that Central and South America did not have capitalism as I define it until the mid-19th century, or 200–250 years after North America. The key differences between North and South America lay in the rich endowments that initially attracted the Europeans to the latter. Those endowments induced the development of plantation agriculture based on forced labor wherever possible, and they were supported by repressive regimes that permitted European elites to dominate society and oppress their own majorities. The focus of government, as backed by military force, was the protection and promotion of elite interests. Central and South American governments were focused on control, not development.

China, with an initial technological stock that was roughly comparable with Europe in 1400, had huge initial advantages in labor supply and inland waterways (an estimated 30,000 miles of canals), yet it was a laggard, only beginning its experiments with capitalist governance circa 1980, or 200 years after France and almost 700 years after Venice. While trade is an important element in capitalism, and trade can travel rapidly from one region to another, the real basis of capitalism lies in the liberalization of factor markets, and that requires the willingness of the rulers to decentralize power in return for the obligation to pay taxes. China was handicapped by a succession of autocratic governments (the Ming and Qing dynasties), a brief interlude of oligarchy, and then communism, which combined to delay the delegation of power for centuries.

As these examples should make clear, the adoption of capitalist institutions is a political decision, and not one based upon the economics of cost effectiveness. The successful evolution of capitalism as an economic system depended upon a political process far more than on the growth of market-based activities such as trade. Governments have to be willing to delegate power to economic actors while holding them accountable, at a minimum, to pay taxes. Too much delegation could lead to the perversion or even destruction of such a system, for example, with an oligarchic takeover. At the other extreme, too little delegation would cripple its capacities for innovation and the generation of increasing incomes and tax revenues. Market actors have only conditional freedoms, which depend upon obedience to the laws and other rules.

Excessive power in the hands of the private sector threatens the political stability as well as the legitimacy of the system. The decision to give up feudalism for capitalism was first and foremost a political decision; it required the assent of the sovereign to permit the purchase and sale of land, the mobility of labor to work for wages, and the right to retain profits from trade. In many cases, including in England in 1688, such delegation of power came after the overthrow of the regime and the signing of an accord between the new ruler and the parliament. Nevertheless, it was up to the successor political authority to govern, albeit according to the fundamental laws of the country.

Capitalism requires the rule of law; it does not require democracy. Repression can be maintained within ostensibly liberal regimes. The southern United States chose to maintain slavery and then segregation within a nominally capitalist system. As they did so they fell behind the North in their development, largely because they failed to develop their infrastructure and their human resources. Market forces existed in the South, but they were not permitted to develop the full range of human skills and abilities, nor were they in any way adequate to end either slavery or segregation. The former was ended by a bloody war that cost the lives of 3% of the population of the United States, and the latter was eliminated through federal laws, federal courts, and ultimately federal marshals and federal troops. Thus the US South had a stunted form of capitalism for more than three centuries; it was partnered with an immoral political system that was only overthrown by external force. Italy has suffered—and continues to suffer—a somewhat similar if less extreme form of distortion. Italian elites, north and south, remain so mired in this corruption that they have been unable to overthrow it. While the Italians have mobilized coercive force to try to curtail or even overthrow the patron–client relationships in the Mezzogiorno, this determination has only been sporadic because its target has been a corrupt system and not one that was obviously immoral. As a result, Italy remains a capitalist democracy that is characterized by "one country-two systems," where a distorted form of capitalism is governed through a corrupt version of democracy.

The Evolution of Internal Governance (and Strategies Imposed from Outside)

The evolution of capitalism has been anything but a smooth, linear story originating with a set of conditions and progressing toward higher forms of organization. Instead it has been based upon scattered origins across a small number of countries, with distinctive patterns of evolution emerging over time within individual countries. These patterns have been dramatically affected by wars and hostile takeovers, as with the French Revolution, the post-World War II surrender of colonial regimes, and domestic revolutions, including the collapse of the Soviet model in 1989.

Capitalist societies can be transformed from within, through reshaping their institutions, for example, the systems of taxation or the tilt of their legal institutions to favor either producers or consumers. The transformation of capitalist systems should be seen as a natural process of development, and a right of sovereign countries. Unlike biological evolution, however, there can be no assurance that the fittest variants are the ones that survive.

Understanding capitalism as a three-level system of governance implies understanding it as a model that can come in many different varieties, both among countries and within countries over time. As I have shown, capitalism at the most general level is a generic system of governance for economic relationships wherein governments create institutions that shape economic markets and the rules of acceptable behavior for the actors, all within the boundaries of a political entity (state). But if we examine capitalism at a more specific level, we see that states, like firms, have priorities at any point in time and can tilt their institutions in light of those priorities. Since societies design and create their own institutions through their governments, each state creates its own variety of capitalism, whether explicitly or not. Varieties of capitalism emerge as varying circumstances suggest varying institutional choices, and all such choices confer an inevitable "tilt" upon certain markets, particularly to most factor markets.

Government, with its ability to pursue intermediate-term goals, has a crucial entrepreneurial role to play in shaping the evolution of capitalism, even including fundamental alteration of its nature and performance. Government has the exclusive legitimacy to make such institutional changes, but, in order to fulfill this entrepreneurial role, it must mobilize sufficient power to prevail in appropriate political markets. Over time, a society can be transformed from an oligarchic capitalist model to a social democratic variant, from a producer-oriented version to the consumer variant, or from a regulated system to one that is more laissez-faire or indeed the reverse. The first change is perhaps the most risky of the three, in that the powerful elites (or oligarchs) must accept a loss of power, typically through the holding of free and fair elections, in which all voters are limited to nominal financial contributions. This shift would likely require considerable internal political pressure to induce appropriate government action. Once the rule of law is accepted, removing the hold of oligarchy over the political and capitalist systems, government can assume its entrepreneurial role with less drastic effects. In other words, the tilt of the institutions in the system, a tilt that favors one group rather than another, can be adjusted with much less risk of the overthrow of the regime once the rule of law is accepted.

Over time, a society's capitalist governance cannot be any better than its political governance. Unlike competitive sports, where technological change may be slow or even deliberately restricted to maintain a pure replica of the sport in an earlier era, the continuing redesign and implementation of improved institutions is critical to effective capitalism over time. Effective governance demands competence from political leaders as well as appropriate representation of various groups. As a result, competition among political parties will be, in part, over differing conceptions of capitalism, as has been the case in the United States at least since the 1870s.

As has been previously stated, good political governance need not be democratic. Indeed, good governance through limited monarchy was the key European contribution to civilization.[12] Democracy came long after the advent of capitalism. As political scientists Gabriel Almond and Robert Dahl have noted, there is a complex interdependence between the political and economic systems of society, an interdependence that is achieved and indeed maintained in considerable measure through their partially overlapping systems of governance. This interdependence has been all but ignored by economists such as Milton Friedman, Douglass North, and many of the Chicago School. Friedman and others have implicitly used the exceptional early circumstances of the United States as the basis of a model of local commerce among atomistic competitors. To use such a model in the 20th century is to ignore the reality of gross inequalities of power among competitors in favor of a fiction based on the mathematics of relatively equal, free, and local competition. It is not just an oversimplification; it permits world-renowned economists to dismiss the very power relationships that are central to the joint evolution of capitalism and political governance (democracy) in all modern societies.

The imposition of a single capitalist model upon countries with very different levels of incomes as well as differing institutional capabilities is a form of cultural imperialism. In recent decades it has been fashionable to suppose that the laissez-faire, Washington Consensus model of capitalism is universally and perpetually appropriate. This proposition is mistaken on both counts. The laissez-faire model, while initially appropriate for the United States, is inappropriate for entrenched aristocracies whose distributions of wealth and power are legacies of feudal regimes. To ignore initial inequalities in imposing a capitalist model is to retard if not preclude the development of democratic regimes in some developing countries. In addition, the one-size-fits-all approach to capitalism ignores the problems of societies trying to establish industrial activities both to diversify their economies and to induce increased investment and more rapid growth. A brief review of US history with capitalism should make that point clear: US capitalism has evolved through time in quite identifiable ways as conditions have changed. To say that the system has remained capitalist throughout more than three centuries of development does not

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[12] See Paddy Ashdown, "Speech to the English Speaking Union" (The Goldsmith's Company London, November 30, 2006).

begin to describe the particular varieties of capitalism that have characterized those three continuous centuries.

The Evolution of Capitalism in the United States

The United States has had a capitalist system of economic governance virtually from the time that Europeans took over the control of the governance of the original British colonies in North America. However, US society started with an exceptional set of circumstances in that its "firms" were primarily one-man operations with virtually no market power; firms thus existed in a fairly symbiotic relationship with the weak government that was favored by its early political leaders. These circumstances changed dramatically after 1840, as the new technologies of the Industrial Revolution created opportunities for increasing economies of scale that induced the growth of larger firms, which soon posed challenges to US capitalist governance, as discussed in Chap. 13. US capitalism threatened to dominate its democratic partner system, thanks to the dramatic growth in size and economic power of industrial firms, where the technological empowerment was augmented by legal empowerments such as the independent existence of firms from the governments that chartered them (*Dartmouth v. Woodward*) and their right to lock in investor capital subject to exclusive decision-making control of the board of directors. States tried to maintain a semblance of accountability through charters of incorporation, which recognized the state as the original grantor of power, i.e., the principal to whom boards owed allegiance for their right to operate. However, favoritism in awarding charters to exercise power and thus earn money induced delay and corruption, leading eventually to a system wherein the granting of charters was based on a simplified application and payment of a fee, as suggested in Table C.1.

The remainder of the 19th century was characterized by the rapid growth of private firms with little accountability to anyone. The 1880s saw the advent of federal regulation, but even those regulations were largely toothless, as they required the approval of the Senate, then a business stronghold populated by senators chosen by state legislatures, which were themselves beholden to business interests. The lopsided power relationship was greatly exacerbated when, beginning in 1888, New Jersey permitted firms to form holding companies that could own shares in firms chartered in other states. Thus, US capitalism was utterly transformed in the direction of giant enterprise by the state of New Jersey, and by Congress' lack of response. State regulatory powers were quickly watered down by the race to the bottom, as states competed to keep corporations from leaving for a more favorable jurisdiction. US capitalists were being given quite extraordinary powers to operate in a rapidly growing market in which they owed society little if anything in return, a pattern that has made US capitalism distinct from its very inception. When Theodore Roosevelt tried to require a federal license to operate in the continental market he failed, as did William Taft, his successor. Had a federal chartering system been adopted, US capitalism would in all likelihood more closely resemble European variants, and notably in the need to accept responsibilities to various stakeholders.

Table C.1 Four phases of US capitalist development, 1630–present

	Phase I (1630–1830)	Phase II (1830–1937)	Phase III (1937–1980)	Phase IV (1980–present)
Firm size	Atomistic <100 employees	Dual economy >100,000 employees	Mixed sizes	Mixed sizes
Market scope	Local	Local and National	National	National and International
Legal empowerment of firms	Charters are granted by states, with conditions Private contracts take precedence over state laws (1789) Lock in of capital (c. 1815) Corporations are independent entities: *Dartmouth College* (1817)	Charters become almost automatic 14th Amendment guarantees owners due process in federal courts NJ authorizes interstate holding companies (1888–1896) Limited liability	FDR finds accommodation with Supreme Court in 1937, reestablishes de facto political control of capitalism	Special legislation creates tailor-made advantages for firms (e.g., earmarks)
Regulatory regime	Firms operate under "grant theory" Caveat emptor Reputation-based regulation	Firms act as independent entities under Classical Legal Thought Weak regulation by Interstate Commerce Commission and Federal anti trust Supreme Court nullifies social democratic legislation	Strong Federal regulation of markets for labor and capital	Deregulation of social system previously based upon segregation and WASP personnel Deregulation of political system Economic deregulation and "regulatory laxity" Shareholder capitalism accords residual profits to shareholders

Table C.1 (continued)

	Phase I (1630–1830)	Phase II (1830–1937)	Phase III (1937–1980)	Phase IV (1980–present)
Accountability	Small firms = Small state Symbiotic balance between private power and accountability to a weak state, but slow process for chartering firms that was marred by corruption	Big firms > Small states States "race to bottom" in laxity of regulation Imbalance tilts power to private sector oligarchy with little accountability to the grantor of the charter	Big firms = Big federal "state" Balance between (federal) power and that of firms = accountability	Political deregulation weakens federal oversight Social deregulation weakens professional standards in accounting, business, and law Powerful firms > Weak state and federal government Imbalance of power permits private oligarchy to obstruct government for the people
Capitalist model	Laissez-faire	Laissez-faire	Social democratic	Laissez-faire
Distribution of wealth	Egalitarian	Concentrated—top 10% (in industry)	Egalitarian	Concentrated—top 10% (in financial services)
Political system	Democratic	Oligarchic	Democratic	Oligarchic

Source: Bruce R. Scott

When state legislatures began to pass stricter regulations, for example, in utility rate making or labor relations, firms could appeal to federal standards on both procedural and substantive grounds of due process under the Fourteenth Amendment, inviting lengthy litigation and great delay. These conditions invited oligarchic development and control of US capitalism until the end of the 19th century, and also the mounting of two counter-movements for reform, the Populists and the Progressives. While both of these movements had some success, for example, in enacting protective labor legislation, the US Supreme Court weighed in as a major force in US capitalist governance by overturning 58 Acts of Congress from 1870 to 1930, compared to only two such actions during the first 75 years of the new Republic. Thus the US Constitution gave firms far more opportunities to find a chartering authority than any other nation, while also allowing its Supreme Court an almost unique role in nullifying the votes of both houses of Congress, houses that would have been a sovereign authority in almost any other democracy. US governance became oligarchic by the 1870s, if not well before, and would remain that way until the Great Depression brought a dramatic realignment both in state and federal legislatures. It took a confrontation between the President and the Supreme Court before the Court would accept that the Constitution did not mandate laissez-faire economics, a point that Justice Holmes had made three decades earlier in his dissent in the *Lochner* case.

Once the change in the Supreme Court membership was effected in 1937, the US moved toward a model of capitalism quite similar to the social democratic models then taking shape in Europe, and remained in that paradigm until 1980, as suggested in Table C.1. Whereas sociologist Charles Perrow could rightly point out that the United States was set on the path toward a dual economy, dominated by giant firms from 1900 on, it was nonetheless able to reform its capitalism through democratic elections in 1932 and 1936 and establish a social democratic model.

The events described in Chap. 14 present a very different picture of how capitalism and democracy can relate to and reshape one another. In Phase IV, instead of business growing radically stronger, as it had for the century after 1830, allowing it to dominate the political process and thus the evolution of capitalist institutions as well until the 1930s, radical change came to US democracy before it did to US capitalism, beginning circa 1965 and stretching until 1980. These leading edge changes were primarily social and political, as explained in Chap. 14, and they initially reshaped US democracy, opening it to increased influence by the people through formal primary elections and a less hierarchical structure within the legislatures themselves. The assumption was, and essentially remains, that government that is more open and more transparent is more democratic and therefore by definition more *for* the people. Unfortunately, the deregulation of the US political system rendered it vulnerable to penetration and domination by special interests and short-term populist solutions. If anything should be clear from the subsequent events, it is that government *by* the people is no assurance of government *for* the people. California is a shining example of just how much damage can be done rapidly through governance based upon simplistic sloganeering.

As I argued in Chap. 14, the challenge now is to reform US democracy as a precursor to the reforms that are needed for US capitalism. US democracy has become too weak to accomplish what is needed. Congress represents entrepreneurial America, in the sense that legislation is for sale to the highest bidder or the most skillful lobbying organizations. Capitalism has thus become further distorted in favor of business interests, and, given the weakness of US democracy, no other interests have the power to turn this distorted set of circumstances around, a point that Simon Johnson makes eloquently in the Epilogue.

The United States faces a real dilemma. Its capitalism needs very substantial reform, but its democracy is too weak to enact such reforms. This is a condition that should attract the attention of our best minds, but some of those who might be best placed to help seem to have missed the point. To illustrate this, the next section details how one prominent and intelligent commentator on US democracy has suggested a solution that seems merely to deepen the problem.

The Future of Capitalism

In a June 2009 cover story for *Newsweek* entitled "The Capitalist Manifesto," Fareed Zakaria aptly summarizes the problems of the US capitalist model today: "The failure of self-regulation over the past 20 years—in investment banking, accounting, rating agencies—has led inevitably to the rise of greater government regulation."[13] And yet, in the following paragraph, he turns a blind eye to the implications of his argument, stating "There's a need for greater self-regulation not simply on Wall Street but also on Pennsylvania Avenue."[14] If self-regulation was the problem, how can it also be the solution? Moreover, given that capitalism is a system of governance, how can self-regulation even be possible? His misunderstanding of capitalism is very close to that of Milton Friedman; both understand it as a one-level system where the rules and regulations reflect consensus and therefore permit self-regulation. The misunderstanding is of great concern, as Zakaria, far from occupying the fringes of public discussion of these issues, often stands at the fore, as a former editor of *Foreign Affairs*, the current editor of *Newsweek International*, a columnist for *Newsweek* and the *Washington Post*, and the host of his own program on CNN, as well as a commentator on the programs of many others. Despite his clear and insightful sense of democracy as a complex governance system, he fails—as many others before him have—to conceive of capitalism as anything more complex than a collection of markets governed by an invisible hand, markets that might be well governed by something as simple as self-regulation. In effect, he treats capitalism as a black box rather than as a system of governance, with institutions as complex as those of democracy.

[13] Fareed Zakaria, "The Capitalist Manifesto," *Newsweek*, June 18, 2009.
[14] Ibid.

In my view, the essential lesson of the last 30 years is that self-regulation of capitalism is an ideological fig leaf that hides a superficial understanding of a system that requires the coercive powers of government to restrain the competitive urges of many of its leading players. Indeed, a belief in self-regulation seems to signal a failure to understand, with any depth, what is happening in a capitalist system. If, after 20 years, self-regulation was revealed as an ineffective strategy, the solution might naturally include more effective regulation, and not a return to the failed recipe of the last quarter century. More effective regulation can *only* come through a political authority. Zakaria's "Manifesto" is thus built upon a crucial oversight, caused by a more fundamental misunderstanding of what capitalism really is.

Capitalism requires a formal system of regulation, as I have argued throughout this book and again in this concluding chapter. This formal system of regulation, like its analogs in professional team sports, depends upon the existence of a legitimate and effective political authority. It cannot be wished away through repeating the mantra of self-regulation. Indeed, effective self-regulation is a chimera in organized competition, at least when there are a large number of participants and something is at stake.

Yet herein lies the dilemma for the United States today, a dilemma that I am surprised Zakaria overlooks, given his outstanding analysis of the US political system in an earlier work, *The Future of Freedom*. In that work, as I discussed at length in Chap. 14, he documents the deregulation of US democracy, which greatly compromised the effectiveness of political governance in the United States. As he notes, the system is much more open, but, as a result, more susceptible to corruption by moneyed interests. The most powerful actors of our capitalist system dominate our political system today. Zakaria fails to address how one can achieve effective reform to the formal economic system absent an effective political system; instead he relies on a new form of "self-regulation" that would not require formal legislation.

His failure to acknowledge the weaknesses of the democratic system seems odd, given his analysis in *The Future of Freedom*. Indeed it is the apparent contradiction between his conclusions in the "Manifesto" and the ones stated in his earlier work that deserves the greatest attention in this concluding chapter: The "future of capitalism," both in the United States and in the global economy, relies on an understanding of the interdependence of the economic and political systems of governance. Reform to the economic system must go through the political system before it can correct the weaknesses of capitalism. Capitalism is ultimately controlled by government itself, not market equilibrium or informal self-regulation. In my view, capitalism requires indirect governance through formal regulation; no form of self-regulation can be anything serious. That would be my Capitalist Manifesto. The alternative to formal regulation is not informal regulation; it is chaos, which then requires massive intervention to save the system, as happened in the United States in September 2008.

My Capitalist Manifesto, such as it is, is derived largely from the US case, and partly from Zakaria's earlier analysis of that case. In the closing sentences to *The Future of Freedom*, he suggested a remarkable perspective on what transpired in the US political domain between the mid-1960s and 2000 when he noted: "Eighty years ago Woodrow Wilson took America into the twentieth century with a challenge to make the world safe for democracy. As we enter the twenty-first century our task is to make democracy safe for the world."[15]

I believe Zakaria's challenge—"to make democracy safe for the world"—would be both more accurate and more prescient were it modified to the effect that the current challenge is to make *US democracy* safe for the world. While this latter statement might well displease many Americans, it nevertheless seems appropriate. Zakaria described four changes to modern democracy—the use of open primaries to select candidates for office, the liberalization of structures and procedures within the legislative chambers, the greatly increased influence of money and lobbying in the political process (due in no small measure to Supreme Court decisions), and the increased usage of direct democracy in the form of the initiative petition—that, as I understand it, have transpired in the United States, and nowhere else. I agree that these changes pose a challenge for both the United States itself and the wider world, if only because the United States remains the world's leading power in economic, political, and military terms. The risk to the world is that the United States will allow the effectiveness of its democratic governance to continue to decline. The problem is not, as he notes, democracy itself. The problem is US democracy.

As unwelcome as the flaws in US democracy surely have become, remedying them is only half of the challenge. The other half is recognizing the unfortunate implications of the changes in US capitalism that date roughly from the 1970s as well, the result of governance changes. The US social system, in which many of the deregulations of the past century were hatched, must change along with its capitalist and political systems.

As noted at the beginning of Chap. 14, American leaders adopted deregulation as a panacea in the 1970s; it was a simplistic response to a rising tide of instabilities that were social and political at least as much as economic. The opening of the US social system had a powerful rationale at the time, originating in response to official segregation in the South and implicit segregation in housing, education, and employment opportunities nationwide, plus the longstanding dominance of a white Anglo-Saxon male culture in many US organizations. But the deregulation of social institutions was not accompanied by new merit-based standards for the succeeding institutions. Prompt achievement of openness, under political pressures to do so, could easily become inconsistent with a patient search for new standards of quality. It was a case where the ends were seen to justify the means, and "political correctness" stifled constructive debate. While the United States achieved increased openness and inclusiveness, its standards of performance in terms of individual merit suffered in the 1970s, most obviously in public education, but, I would argue, much more broadly in its law firms, accounting firms, and other professional service organizations as well, and not least in its business organizations. Where a sense of public service had been a widespread value in the 1950s and 1960s, opportunism became

[15] Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad*, 256.

a much more accepted standard of value, notably in US firms, as pointed out by Ghoshal.[16] Opportunism cannot be an acceptable standard of behavior for a country that would sustain a high standard of living in a competitive world, let alone for a country that would like to retain its legitimacy as a world leader based in part on the upward mobility of its citizens in a merit-based promotion process.

There was a positive rationale for opening the US political system, to invite greater participation and transparency, for example, through open primaries and caucuses and less hierarchy in legislatures. However, when these changes were made without offsetting institutional changes to maintain non-monetary forms of coordination within their governance structures, the results were similar to those in the economy: a flawed sense of order was replaced with disorder sometimes bordering on chaos. One result, arguably, has been a commercialization of standards throughout American society; the intrinsic values of the earlier system, however imperfect or even flawed they might have been, were displaced by the almighty dollar as the new American standard. The arbiter of quality became money, as the undoubtedly objective measure of market values, and those with the most money became ever more influential in setting standards for the country, in politics and culture as much as in product markets. Given the increasing concentration of wealth in the hands of the top 10% of the electorate, and more particularly in the financial services sector, the result was corrosive to American democracy and capitalism, as well as American culture.

A host of other problems has made it difficult to apply traditional standards. The shift in relative incomes in favor of the financial services sector has induced a migration of top students at top universities in its direction, and toward economics and business as fields of study, reinforcing the role of business values in American society. And, from my personal experience as a faculty member at one of the well-established US business schools, I find very little to cheer about in these trends. Business education has lost touch with the notion of teaching about the responsible exercise of power in favor of teaching people how to promote their own careers in a system focused on heaping huge rewards on those who manage money, even though there is no established link between these financial activities and the welfare of society. A small wealthy elite has achieved great power in the United States, and has been promoting its own interests, much as they were at the end of the 19th century and into the early 20th century.

As the 21st century begins, the United States has once again permitted the growth of giant firms, for all practical purposes suspending the antitrust laws since 1980. These firms, however, have nothing like the dominance relative to government in terms of employment or assets that they had in the 19th century. The crucial source of their resurgent power has not been their growth per se, but instead the weakening of the federal government itself through the various acts of deregulation that began in the 1970s, and especially through their impact on the political pressures facing congressmen. Democracy has been subverted by the poorly conceived political

[16] Ghoshal, "Bad Management Theories Are Destroying Good Management Practices."

reforms noted in the previous chapter. Government has become more truly *by* the people, but thanks to those reforms, less truly *for* the people.

The one clear exception to the moderate growth in corporate power has been the radically increased power of the US financial sector. Indeed, the most clear and present danger to democratic governance in the United States at the present moment seems to rest in the extraordinary wealth and power of the US financial sector. It may not have the power to govern, but it certainly seems to have the power to deregulate its activities and to block real reform from the moment that the leading banks were freed from their ties to government through credit guarantees.

Fixing the US governance systems—economic, political, and social—poses the foremost challenge for Americans in the new century. Confronting the rogue behavior of its financial oligarchy will be the key measure of successful reform. For the United States to remain a model to the rest of the world, it must ensure that its system really works. Recent events clearly question the effectiveness of the capitalist model in the United States, and, as this book shows, questioning the US capitalist system necessitates questioning its political and social systems as well. To remain a legitimate world leader at any level, the United States will need to reform its own systems, a process that will require loosening the hold of oligarchic interests over each one of those systems. Given where we are now, quite behind in reforms to mitigate the effects of the recent financial crisis, and failing to recognize the power of money to thwart reforms, achieving the needed changes will be vastly more difficult, and therefore uncertain of success than public dialogue in the United States would suggest. We must acknowledge what caused the financial crisis, and recognize its roots in US-sponsored theories, institutions, and policies. We lead from a position as the number one source of the problem, with scant inclination to consider such a possibility. It is our shallow ideas of deregulated society led by deregulated capitalism and deregulated democracy that must be overturned if the world is to prosper in a harmonious way.

Epilogue
The Financial Crisis of 2007–2009

Laissez-Faire Capitalism; or Self-Regulation and Crisis

The sweeping deregulation of the three US social systems—political, social, and economic—altered US capitalism and democracy in ways that might seem hard to imagine. While the specific forces driving deregulation in the three areas were quite different, as we have seen, the fundamental idea was the same in all three areas, i.e., markets could regulate themselves with little or no oversight by clumsy if not incompetent bureaucrats or indeed any form of political authority at all. Effectively, this meant that commercial values were to set the standards in almost all areas. Professional service organizations, including law, medicine, and even educational institutions, were all pulled in a similar direction of seeing themselves as businesses to be run more and more by business values, i.e., as profit-making entities and not just as professional service agencies. Educational institutions focused increasingly on meeting customer needs and desires relative to transmitting a set of skills and values assumed to reflect societal priorities. With the highest salaries centered in financial services, business schools became increasingly focused on teaching financial analysis as contrasted with management, and Harvard Business School, as a school with a 75-year tradition based on teaching general management, abandoned that tradition in its required curriculum in favor of a second required course in finance.

The effect of reliance on deregulation as a panacea was a huge transfer of power from the visible hands of various agencies of political and regulatory authority to the market actors themselves. They were to regulate themselves, perhaps along lines that had been well established among the professional service firms. However, deregulation and decentralization had also curbed the powers of private authorities in organizations based upon white Anglo-Saxon and male dominance, where selection had also been on the basis of rankings in exclusive universities and clubs, in favor of the so-called invisible hands of markets. Effectively, this meant a huge transfer of political power to those with the economic power to manipulate those markets. Given its vast increase in power since 1980, the single most important beneficiary of these changes was the financial services sector, or Wall Street for short. Over time, these same trends would have very considerable implications for business acceptance of risks, including laying the groundwork for the financial crisis that first became visible in August 2007.

This most recent financial crisis was not caused by unforeseen accidents, such as the shock of a war or a Tsunami or an embargo of oil supplies; instead it was caused by mistaken ideas and beliefs among the major actors themselves. These mistaken ideas led to repeated policy mistakes.[17] The crisis did not start in the "real" economy, as crises usually have, but instead in the financial sector, which had become increasingly leveraged since 1980. In an ideological sense, that increased leveraging stemmed from two beliefs: first, a naïve belief in a self-regulating model of capitalism, where excesses could not occur and therefore had not occurred, and second, an established set of ideas in the US as a powerful country that need not heed the normal rules of international commerce, such as earning what it consumed. In a practical sense, the increased leverage was the route to much higher profitability, which was calculated as returns on equity and not returns on total capital employed. More borrowing and more leverage meant higher returns on equity in any event, and even higher returns so long as asset prices rose. In the event, prices for US financial assets rose for almost 20 years from 1982 to 2000, and then again when the Fed flooded the economy with money in 2001 to respond to the bursting of the dot.com bubble.

Congress and the various regulatory agencies granted increased power to markets, and especially to the largest players within them who could, as noted above, lobby to promote their interests. Instead of guarding against the possibility of over-leveraging, the authorities were assisting the process with cheerful abandon. For example, in 2004 the SEC changed its rules to allow the investment banks to set their own levels of acceptable leverage, and stood passively by as their leverage rose to and even surpassed 30–1. The financial crisis emerged in plain sight, but, given the blinding beliefs held by the market actors, the regulators and indeed much of the US academic community, it was not even recognized for months after it began to unfold, let alone foreseen in advance. Accordingly, obvious corrective measures were not taken until the horses were out of the barn, so to speak. And one of the surest "lagging indicators" that the crisis was caused by faulty ideas and irresponsible policies rather than unforeseen events was the fact that, even 2 years after it first emerged, there had been no serious inquiry into why it had occurred. Any such inquiry was bound to be embarrassing for US leaders in business, government, and academia, and especially for those who had espoused the notion of self-regulating markets while in positions of regulatory responsibility, thus providing a rationale for their own passivity in high office in time of crisis.

Paul Volcker, in a speech to The Economic Club of New York in April 2008, identified the broad outlines of both the faulty ideas and the policy failures behind the crisis. It seems to me that his analysis has been underappreciated and his role in

[17] David A. Moss, "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail'," *Harvard Magazine*, September/October 2009, 25–26, http://harvardmagazine.com/2009/09/financial-risk-management-plan.

the Obama Administration marginalized. I draw extensively upon his analysis here, supplementing it with illustrative exhibits that he did not use, perhaps because he could assume that his particular audience did not need to be reminded of the basic data.

In his remarks, Volcker pointed out that, prior to 1975, the United States "had been free from any sense of financial crisis for more than forty years," as shown in Fig. E.1.[18] Those 40 years (1933–1975) were characterized by a "commercial bank-centered, highly regulated financial system" that was then succeeded by "an enormously more complicated and highly engineered system . . . [where] much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments."[19] As Volcker noted, the new system "has been a highly profitable business with finance recently accounting for 35–40% of all corporate profits," far higher than the 16% of the earlier, more regulated system.[20] Despite these profits, the new system was fundamentally unsound, as Volcker noted: ". . . today's financial crisis is the culmination . . . of at least five serious breakdowns of systemic significance in the

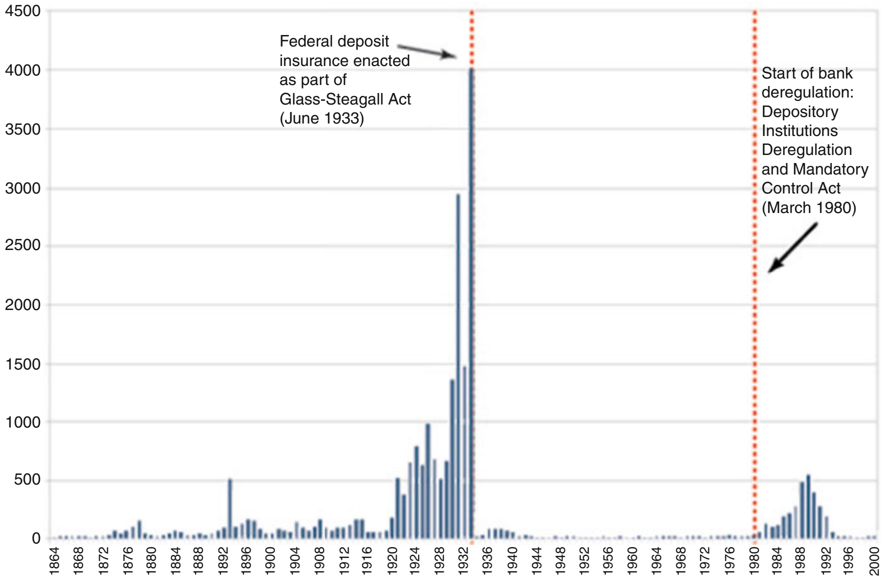

Fig. E.1 Bank failures in the United States, 1864–2000. Source: David Moss, "An Ounce of Prevention: The Power of Public Risk Management," Harvard Business School Working Paper 09-087, January 2009, published as "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail,'" *Harvard Magazine*, September-October 2009

[18] Volcker, "Keynote Speech."

[19] Ibid.

[20] Ibid.

past 25 years, on the average one every five years. Warning enough that something basic was amiss."[21]

Why had this newer system broken down so often and with such unfortunate consequences, notably the crisis of 2008? As Volcker made clear from the outset, the problem was not a small one: "Simply stated, the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the market place."[22] Moreover, he noted that the steps taken to solve it would imply problems of their own: "To meet the challenge the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied owners, transcending certain long embedded principles and practices."[23] Foremost among these unusual measures was the direct extension of credit to non-banking institutions such as Bear Stearns, a measure that Volcker feared might be seen as "an implied promise in times of future turmoil."[24] Acceptance of potentially toxic mortgage paper as collateral for credits from the Federal Reserve was also a clear violation of a familiar central banking mantra—"lend freely at high rates against good collateral."[25] The new system had clearly failed, and the steps taken to address it seemed problematic. (Six months later, after the bankruptcy of Lehman Brothers, the problems were still more obvious, as the system went to the verge of a total meltdown right under the eyes of the regulators.)

What had changed in the system that could possibly account for such a failure? Volcker noted the shift toward greater and greater deregulation in the industry: "Today, much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments."[26] Instead of protecting these markets through clumsy, official regulation, they were protected by the so-called efficiencies of the free market. In practice, these efficiencies meant the nimble hands and minds of the private sector, for example, through their creation of a new market for so-called credit default swaps. Rather than rein in excessively risky behavior, as regulators might have done, private actors would provide insurance against the risks, thus providing a market-driven solution. Credit default swaps mushroomed from near zero in 1999 to a gross value of about $70 trillion 8 years later, with such growth seen as a natural and beneficial result of free-market forces. From a practical viewpoint, these unregulated swaps offered unusual profit opportunities because they were a form of insurance that did not have to be backed by reserves in the manner of a regulated insurance industry.

Volcker noted the purported advantages of the new system: "In the new paradigm, the intermediation process has increasingly become the domain of the open market. The general idea is that the inherent risks can be minimized by un-packaging the

[21] Ibid.

[22] Ibid.

[23] Ibid.

[24] Ibid.

[25] Ibid.

[26] Ibid.

institutional relationships, separating maturity and credit risks, 'slicing and dicing' so that those risks can be shifted to those most willing and capable of absorbing them."[27]

Central to the new system and its unregulated, free market underpinnings was a methodology prioritizing objectivity, i.e., numbers, over all else. As part of the removal of regulation, mathematics and market reasoning replaced purportedly biased and erroneous human governance. But in the process, it removed the basis of what Volcker calls the underlying trust between market participants, trust that would prove necessary when the numbers failed. Clever equations and mathematical models spread risk among borrowers and lenders who did not know each other, did not check up on their credit histories; the lenders simply focused on making transactions in order to collect the transaction fees prior to selling off the paper to a third party. Even the investors buying up the borrowers' paper relied on numbers, in the form of third-party ratings from allegedly expert and neutral sources, to determine the quality of the paper. They all trusted the numbers, and had no reason therefore to have to trust the people behind them.

However, the numbers, i.e., the credit scores and ratings, proved outdated and flawed. As Volcker states, "Mathematical modeling, drawing strong inferences from the past, has demonstrably failed to anticipate unexpected events of seismic importance ... mathematical modeling simply cannot deal with markets where it is not random or physically determined events but human instincts that cause self-perpetuating waves of unwarranted optimism or pessimism."[28] Without the numbers to rely upon, there was no other basis for trust in the system and so, in Volcker's words, it fell apart: "The sheer complexity, opaqueness, and systemic risks embedded in the new markets—complexities and risks little understood even by most of those with management responsibilities—has enormously complicated both official and private responses to this current mother of all crises. Even previously normal trading relationships among long-established institutions are questioned. What has plainly been at risk is a disorderly unraveling of the mutual trust among respected market participants upon which any strong and efficient financial system must rest."[29]

Not only did the numbers backing the new system prove flawed, but the assumptions of the larger context in which the new, unregulated system was embedded proved flawed as well. Housing prices had never gone down all across the country, and thus it was assumed that they never would. Losses in one area would be offset by gains in another: Borrowers could keep on borrowing, lenders could keep on lending, and investors could keep on buying up the new, engineered products which had been "sliced and diced" to meet their very diverse preferences. Overall, the country could increasingly depend on debt as a source of financing because the risks were more widely distributed among investors who were assumed to be able to bear such risks.

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[27] Ibid.

[28] Ibid.

[29] Ibid.

It was a system based on the notion that regulation by any entity other than free-market forces was unnecessary and inefficient; indeed who is responsible for or even able to question these flawed assumptions and, if necessary, to set limits on the leverage? The question is not for idle speculation, since, as Volcker notes, "Financial crises typically emerge after a self-reinforcing process of market exuberance marked by too much lending and too much borrowing, which, in turn, develop in response to underlying economic imbalances."[30] Without anyone in charge—besides the invisible hand of the market—no one was overseeing the cycle that led to imbalances and eventual crisis. Total debts outstanding in the United States credit markets increased from about 150% of GDP in 1977 to 350% by 2007, as shown in Fig. E.8.

Proponents of the system argue that it permits greater efficiencies through widening the variety of instruments available to investors, as well as widening the pool of investors, and together these changes permit greater overall security through diversification. But were there imbalances in the system, as Volcker suggests and, if so what were they?

Consider a few figures on the macroeconomic context of the time. One economic imbalance that had been visible for more than a decade was the simultaneous rise in household debt and decline in household savings. Household debt relative to income was regularly reported, and as Fig. E.2 shows, the numbers increased by 100% between 1980 and 2006, with half of increase occurring between 2000 and

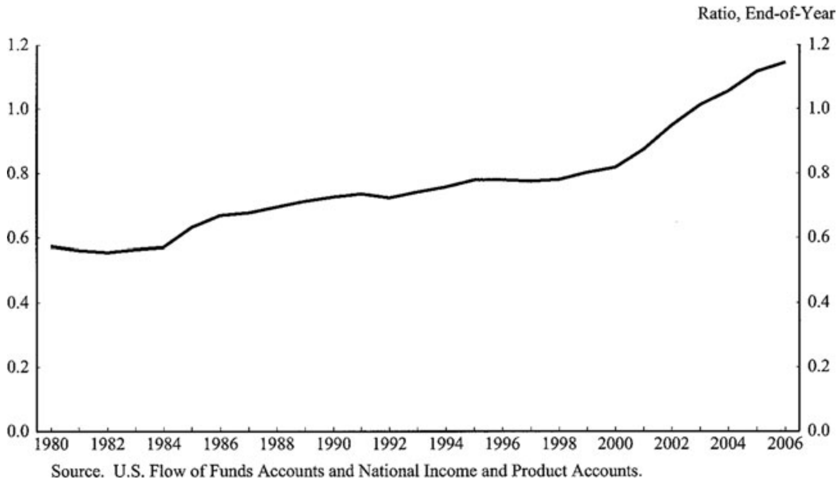

Fig. E.2 Ratio of household sector debt relative to personal income, 1980–2006. Source: Karen E. Dynan and Donald L. Kohn, "The Rise in U.S. Household Indebtedness: Causes and Consequences." Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs (Washington, DC: Federal Reserve Board, August 2007), 37, Figure 1 (http://www.federalreserve.gov/Pubs/Feds/2007/200737/200737pap.pdf)

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[30]Ibid.

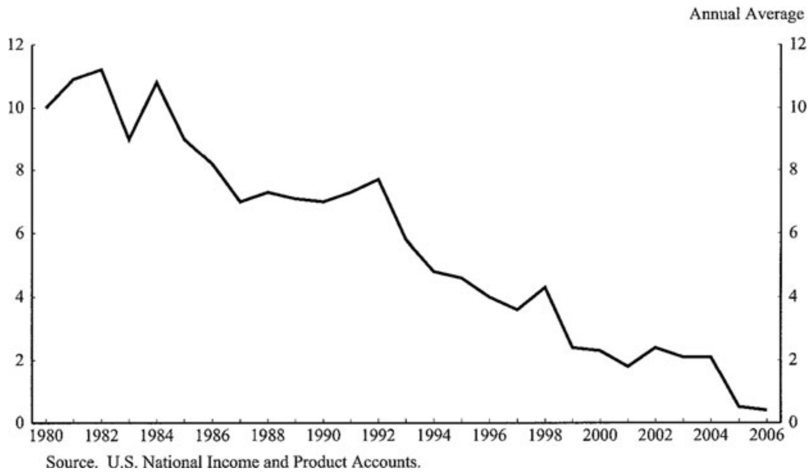

Fig. E.3 Personal saving rate. Source: Karen E. Dynan and Donald L. Kohn, "The Rise in U.S. Household Indebtedness: Causes and Consequences." Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs (Washington, DC: Federal Reserve Board, August 2007), 37, Figure 1 (http://www.federalreserve.gov/Pubs/Feds/2007/200737/200737pap.pdf)

2006. While interest rates had declined somewhat during these years, reducing borrowing costs relative to incomes, these numbers implied a rising debt service or leverage burden for consumers and thus rising risks if something should happen to their incomes.

Meanwhile, household saving in this same period had declined from 10% of GDP to near zero, as shown in Fig. E.3.

This connection was not simply problematic because of the US addiction to consumption and ultimate reliance on foreign funds that it implied. It was also an issue when one considered the fundamental value of what was being mortgaged, i.e., houses. Consider the data on the mortgage market. First, as household savings declined and debt increased, homeowner's equity as a percentage of household value dropped from 70% in 1980 to about 50% in 2007. The rise in household borrowing was linked to homeowners drawing down of the equity held in their own homes, or trading up to higher priced homes because they were a "good investment," i.e., housing prices were rising. Investing in housing had been a great bet for more than 20 years, and it was a bet where ordinary citizens could use leverage to ramp up their returns on equity like a professional investor.

Second, to worsen matters, the actual assets being bought by the homeowners, on credit, were inflating in price relative either to rental incomes or to building costs. Figure E.4 shows that the price was appreciating more rapidly than rents or building costs, indicating a potential housing bubble that began to manifest itself in about 1997, or roughly a decade before the housing bubble burst. Thus, individuals were borrowing more to purchase assets in a market where housing prices were rising

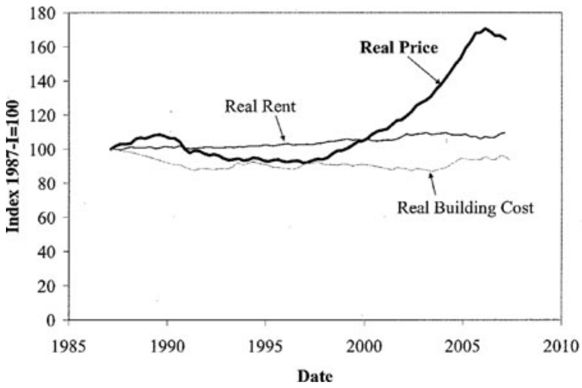

Fig. E.4 Housing prices relative to rent and cost, in real terms, 1985–2007. Note: Real US Home Prices, Real Owners Equivalent Rent, and Real Building Costs, quarterly 1987-I to 2007-II. Source: Robert J. Shiller, *Understanding Recent Trends in House Prices and Home Ownership*, NBER Working Paper No. 13553 (Cambridge: National Bureau of Economic Research, October 2007), 41, Figure 1

relative to their underlying value measured either in income earning potential or replacement cost.

These data alone should have indicated to those in charge, or really any serious analyst of the industry, that a problem had emerged, was worsening, and would not likely be solved by markets alone. But homeowners and analysts alike simply assumed, as noted above, that housing prices would never fall. And who, if not a regulator, had an incentive to blow the whistle, as buyers and sellers alike benefited (albeit in the short term) from the bubble? If the regulators along with many journalists and academics believed that markets were always right, who was left to sound the alarm?

A look at the historical data strongly suggested that rising home prices were not indications of healthy market but rather of a bubble rather like that of Japan a decade earlier. Why was this housing bubble allowed to continue? Unusual lending practices helped finance it; and notably the creation of new mortgage products that started out with low interest rates and sometimes no down payment required. So-called adjustable rate mortgages were just the kind of product that the newly legislated function of the Fed was designed to question, while even more aggressive or predatory practices, where the true costs were hidden from the borrower, could have been forbidden. The chief regulatory authority for all mortgages, the venerable Federal Reserve, announced that it would not regulate home mortgages even though specifically empowered to do so by Congress in 1994 with the passage of the Home Ownership and Equity Protection Act.[31] The Federal Reserve

[31] See Home Ownership and Equity Protection Act 1994 (Title 15, Chapter 41, Subchapter I, Part B, Section 1539: Requirements for certain mortgages), Section L (Discretionary regulatory authority of Board), Part 2 (Prohibitions), Sub-parts A and B.

Board, chaired by Alan Greenspan at the time, actively avoided these new regulatory powers; as Charles Morris states in his book on the crisis, "... Greenspan had no interest in looking into growing signs of predatory behavior in the subprime industry."[32] Regulation, it seemed, was better left to private markets.

But this poorly regulated environment gave rise not just to its unquestioned efficiencies through greater diversification of risk but also to distortions and deceptions, and consequently to additional risks. Potential homeowners could obtain homes with less than a normal down payment or none at all; they could borrow with lower incomes than were normally required, and with little to no proof of an income record. Lenders could count on selling off the underlying paper for quick profits without worrying about its quality. Ratings agencies could keep building their business as financial institutions, first by applying their century-old methodology and rating systems that had been based on rating ongoing businesses and government agencies, all of which had continuing revenue streams for the borrowers, to these new, quite different products that produced no revenue stream for the borrower, while both borrowers and lenders neglected these differences in the two types of credits.

"Triple A" ratings from the three established rating agencies were as famous as Coca Cola, yet they were allowed to be used in rating asset-backed paper such as mortgages or auto loans, where the rating agencies had little or no experience. With little experience and virtually no regulation, the rating agencies could start with relatively high ratings while they learned a new line of business, a choice that would keep the mortgage issuers happy. Foreign investors could achieve relatively high yields on their money, believing in this world famous rating system yet unaware that it was now being employed in areas where the three rating firms had very little experience. Triple A paper from the United States was about as good as it could be, unaware that asset-backed paper (mortgages, car loans, or even credit card loans) might not be nearly as credit worthy as the paper of ongoing firms and government agencies with their revenue streams. It was bait and switch.

But the problem was not confined to homeowners borrowing more; there was another level to this problem, that of the US economy as a whole. The same addiction to debt can be seen at the level of the country as a whole. The United States was borrowing more relative to its level of income as measured by GDP. The current account deficit hit $500 billion roughly in 2000, and by 2006–2007 was at $800 billion, as seen in Fig. E.5.

What these data say, collectively and unmistakably, is that the United States—at the level of households and the country itself—was spending more of its income and saving less, to the point where it was saving nothing at all. Furthermore, as domestic savings decreased the credit came increasingly from foreign sources, as the relative current account deficits of leading countries, shown in Fig. E.6 make quite clear.

How exactly did this imbalance, linking US debt and foreign investors, come about? Volcker summarizes: "It is the United States as a whole that became addicted to spending and consuming beyond its capacity to produce. The result

[32]Morris, *The Trillion Dollar Meltdown*, 69.

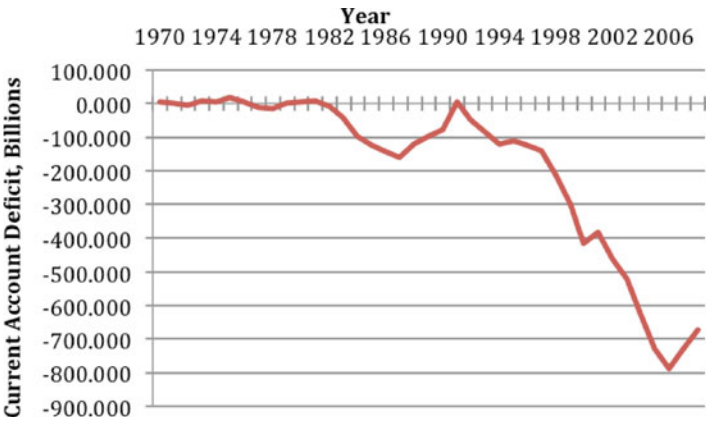

Fig. E.5 US current account deficit, 1970–2008. Source: *Balance of Payments and International Investment Position Manual* (International Monetary Fund, 2008)

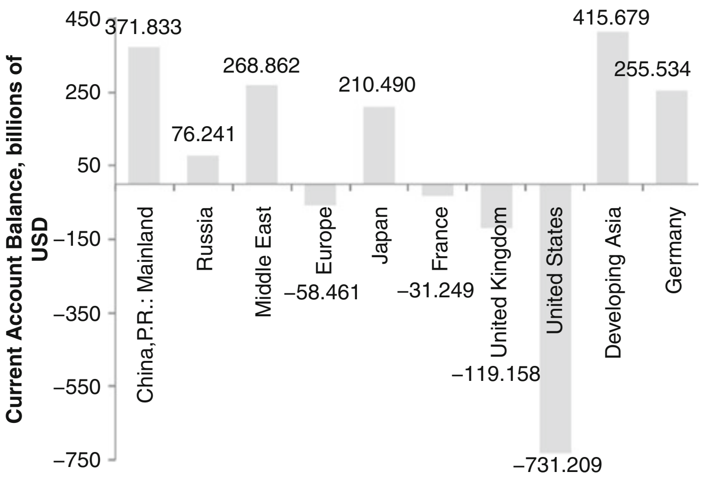

Fig. E.6 US current account deficit, relative to other leading countries, 2007. Source: *Balance of Payments and International Investment Position Manual* (International Monetary Fund, 2008)

has been a practical disappearance of personal savings, rapidly rising imports, and a huge deficit in trade. The process has been extended by the willingness of other countries—foreign investors, businesses and governments—to close the gap by buying our Treasury securities, by indirectly financing our home buyers as well as our banks, and increasingly by buying into our businesses."[33] While Volcker did not go into much detail, the following provides some figures and explanation supporting his analysis.

[33] Volcker, "Keynote Speech."

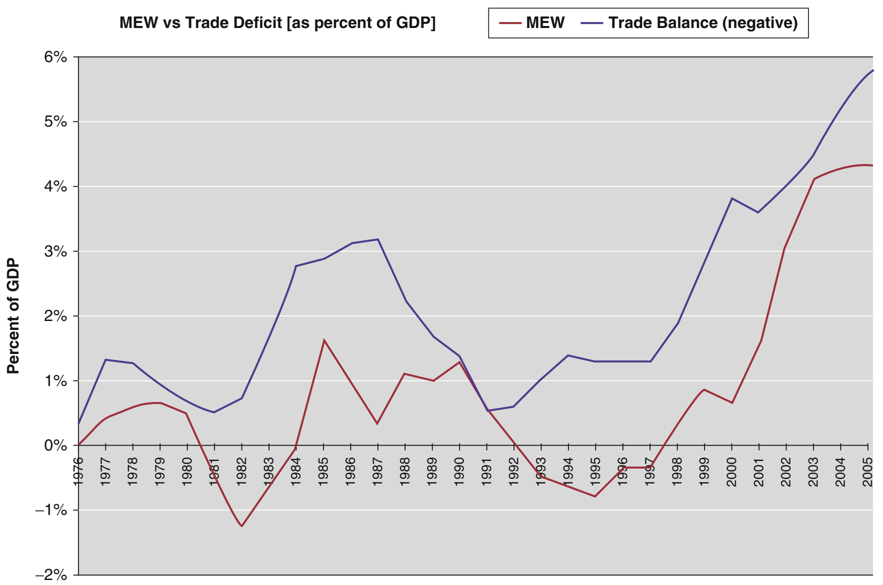

Fig. E.7 MEW versus trade deficit (as percent of GDP). Source: "Mortgage Extraction and the Trade Deficit," Calculatedrisk.blogspot.com, September 24, 2006 (Accessed June 17, 2009)

As households took on greater debt, they did so mainly by withdrawing equity from their homes in a "mortgage equity withdrawal" (MEW). From about 1998 onward they drew down far more than they were paying in on those mortgages, as shown below in Fig. E.7. Interestingly, these mortgage equity withdrawals have roughly tracked the annual current account deficits from about 1998 onward, in a set of transactions where the homeowner withdraws money on his mortgage to finance school tuitions, or perhaps a home improvement, and the bank sells the mortgages either singly or in a package to an institutional buyer who will at some point sell it to a foreign buyer. While funds are fungible, the amounts are so large that the United States has relied on foreign sources of funds to finance most or all of its mortgage equity withdrawals since about 1998.

The United States as a whole could continue to accumulate capital to feed its "addiction" to consumption, while touting how attractive the country must be given the huge foreign capital inflows. The reasons were self-evident; since markets were efficient investors would not be shipping their funds to the United States unless it was a good bet. Markets were not just considered a coordinating device in an economic system; they were considered *the* governance mechanism because many independent economic actors were obviously a better source of governance than any bureaucrats, no matter how skilled.

Perhaps the most problematic element in this picture was the distorted incentive system of the lenders, as Volcker highlighted in his speech. Banks could originate mortgages and get paid back when they sold the mortgages to an investor. The more mortgages the bankers could originate, securitize, and sell, the greater their pay, and the better ratings that agencies gave to those securities, the more business they attracted. Bankers engaged brokers to help boost volume, and the latter were paid based on the quantity of money lent. Since the bank kept little if any of the credit risk on their balance sheets, repayment was a problem for the ultimate investors. Credit rating agencies earned their fees directly from the same institutions whose new, complex products they were rating (with old and thus inappropriate models based upon their experience with loans to organizations that generated incomes, e.g., the bonds of corporations or state governments), risking a loss of business if they allowed the ratings to fall. In neither case did the relevant regulatory agencies step in to investigate what was happening. While some thought of British regulation as based upon a "light touch," SEC regulation of the mortgage-backed securities was close to no regulation at all. Volcker summarized the problem with respect to the lenders' incentives: "Perhaps most insidious of all in discouraging discipline has been pervasive compensation practices. In the name of properly aligning incentives, there are enormous rewards for successful trades and deals and for loan originators. The mantra of aligning incentives seems to be lost in the failure to impose symmetrical losses—or frequently any loss at all—when failures ensue."[34]

Volcker was not alone in indicting the incentive compensation practices that aggravated the imbalances of the new system. Martin Wolf, writing in the *Financial Times* in January 2008, was, in fact, far more pointed. According to Wolf, "By paying huge bonuses on the basis of short-term performance in a system in which negative bonuses are impossible, banks create gigantic incentives to disguise risk-taking as value-creation."[35] Wolf also noted how the banking industry had not only individual incentives encouraging risky behavior, but also industry-wide incentives, in the sense that participants on the whole assumed that outsiders—the government—would simply come to their aid. In Wolf's words, "No industry [compared to the banking industry] has a comparable talent for privatizing gains and socializing losses. Participants in no other industry get as self-righteously angry when public officials—particularly, central bankers—fail to come at once to their rescue when they get into (well-deserved) trouble."[36]

Thus we arrive again to the question, stated above: Who was responsible for overseeing these trends, from the debt spiral to the distorted behavior underlying it? While anyone might theoretically have seen what was happening, nobody other than the most senior regulators could conceivably have had the ability or the credibility —not to mention the incentive—to do anything about them. Volcker pointed to the Federal Reserve as the responsible agent in times of such crisis: "Financial crises are most damaging when underlying economic forces are out of kilter, and when the bursts of self-reinforcing enthusiasm or fears take hold. It is the basic responsibility

[34] Ibid.

[35] Martin Wolf, "Why Regulators Should Intervene in Bankers' Pay," *The Financial Times*, January 16, 2008.

[36] Ibid.

of a central bank—most decidedly of the Federal Reserve, the influence of which spreads worldwide—to balance and moderate those forces."[37]

Unfortunately, the Federal Reserve had different ideas. As previously stated, it had rejected the opportunity to regulate mortgages as early as 1994. In addition, it had explicitly rejected the notion that it had responsibility for evaluating asset prices as indicators of inflation, either in the stock market or the bond market. Markets could make those assessments better than any regulator. Asset prices were outside the purview of the regulatory authorities, and in any case rising prices were a sign of strength and not weakness. The same logic of nonintervention applied to the subsequent bubble in housing prices. The invisible hand of market forces was considered a far superior arbiter of how to use societal resources than any visible hand a regulatory authority could offer.

Alan Greenspan, in testimony to the Senate Committee on Finance in June 2005, indicated just this confidence in the markets to identify and "solve" such macroeconomic imbalances: "Financial markets, if left free to continuously re-price interest rates and asset values, will identify and respond to imbalances far sooner than a system based on administrative edict. In market-based financial pricing systems, automatic adjustments are inherent. But in a highly administered system, supervisors can identify emerging imbalances only when these imbalances become visibly large and are already troublesome. Adjustment in a system requiring human intervention is accordingly far less flexible than in a system based on the automaticity of markets."[38]

Greenspan was restating the theory of efficient markets, crucial to free-market ideology. Since unregulated markets were efficient, by definition, the existence of an imbalance in the United States current account was an indication that the United States was a great place to invest, and not an indicator of excessive consumption relative to incomes and thus an indicator of inadequate saving, as Volcker claimed and the data seem to show. The efficient markets theory had the great merit of being un-falsifiable. Capital inflows signified market opportunities being met silently and efficiently; they were not a sign of irresponsible policies that were promoting excessive consumption while sustaining domestic demand and a rising standard of living. Regulation, therefore, was not needed and, moreover, was undesirable, as it would distort the efficient workings of free markets.

Greenspan and the Federal Reserve were not alone in subscribing to the theory of efficient markets, or a model of laissez-faire capitalism, and in contributing to the roots of the crisis. Congress also took part in facilitating the notable lack of regulation in the new financial system. As other poignant examples, consider the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 and the Commodity Futures Modernization Act of 2000. These two acts, respectively, tore

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[37] Volcker, "Keynote Speech."

[38] Alan Greenspan, "Testimony of Chairman Alan Greenspan: China" (Committee on Finance, U.S. Senate, June 23, 2005), http://www.federalreserve.gov/boarddocs/testimony/2005/20050623/default.htm

down the barriers between banking activities, allowing formerly restricted commercial banks to engage in risky securitization, while also allowing such securitization to exist, free of any official oversight, even by a formally standardized market for trading. Furthermore, they authorized the launching of the credit default swaps as an unregulated insurance industry that could book profits without the handicap of having to provide reserves in case of a default. In a sense, they were forerunners to the debacle at AIG, which had been a leader in writing the swaps, qualifying through mid-2009 for $180 billion in government funds so that it could make good on its insurance commitments. As the markets maintained their inimitable equilibria, they were based upon unregulated transactions where allegedly sophisticated investors either did not know what they were doing or were making too much money to care, assuming that someone else would inherit the clean-up responsibilities.

Re-empowering the Financial Sector

Wall Street players have been criticized by many for engaging in the risky practices, some of which are noted above, and thereby contributing to the crisis. But the extent of their empowerment by this new system, and their ongoing ability to sustain the system even now, has received less attention than I think it deserves.

Key to highlighting the importance of this issue is data on the growth of financial leverage relative to GDP, i.e., a measure of debt relative to the incomes which can service that debt in case of a disruption to the system. The aggregate results of deregulation in the financial sector over time include a steadily rising debt to GDP ratio from 1982 onward, as shown in Fig. E.8. These data are regularly reported by the Federal Reserve, and they seem to be just as regularly ignored. This graph, which traces the financial leverage in the US system from 1929 through 2008, shows that this measure of aggregate financial leverage more than doubled relative to GDP between 1982 and 2008. At first sight this means that the risks in the system had increased dramatically, though not proportionately across the major sectors, and perhaps not quite so much if these risks were more widely distributed to qualified investors.

First consider the increases. The big growth in proportional terms was not in borrowing by government. Nor was there much of an increase in private corporate debt relative to GDP. Instead the increases were in government-sponsored entities such as Fannie Mae and Freddy Mac, in the financial services sector, and in household debt, whether for homes, autos, or credit cards. To simplify, the increases were not to finance productive assets so much as to finance more and larger homes and other consumer items, plus a much larger financial services sector that was financing more assets by using higher ratios of leverage.

This rise in leverage was indicative of an increasing "financialization" of the US economy. There was more debt outstanding relative to GDP, and thus more opportunity for the financial services sector to earn income from granting the loans or underwriting bonds for any given level of GDP. In fact, the financial services sector had more than doubled its share of total corporate profits from 1980 onward,

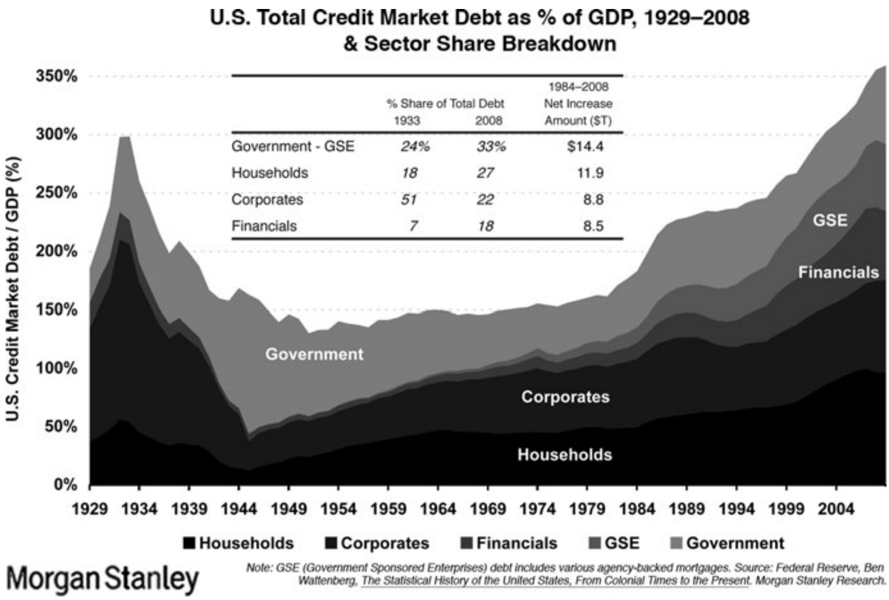

Fig. E.8 US total credit market debt as percentage of GDP, 1929–2008 and sector share breakdown. Source: Adapted from Mary Meeker, Morgan Stanley, "Economy + Internet," March 20, 2009. Posted to Sherpalo Ventures Web site, www.sherpalo.com/resources/TECHTRENDS032009FINAL-1.pdf

from about 15% to about 30% as shown above, and it had almost doubled its per capita earnings relative to the US average. Here was the key to the economic power of the new oligarchy, with its financial muscle right out in plain sight. Financial services had risen to become the dominant sector in terms of profits and average incomes. These resources enabled it to influence the agencies in charge of regulation of the financial system and at the limit to subvert the processes of regulation altogether. It was up to Congress to empower the regulators to do their job, and up to the regulators to fulfill their mandated functions. Congress had not mandated any guidelines for leverage; such guidelines would imply the regulation of assets as well as incomes, and the US Fed refused to accept any such responsibility absent such a mandate. Lobbying pressures from the industry were a barrier to this form of oversight. Leverage in the US economy more than doubled from 1980 until 2008, as shown above (in Fig. E.8).

The redistribution of power in favor of the financial sector, based in large measure on allowing it to increase its use of leverage in search of greater profits, created greater risks, including risk of the downfall of the new system. While the system could weather the forced sale of Bear Stearns to J.P. Morgan-Chase, and even the takeover of Fannie Mae and Freddy Mac, it could not withstand the disruption caused by the bankruptcy of Lehman Brothers. This caused a panic, which disrupted even the short-term money markets and required the authorities to guarantee all money market funds in order to prevent an incipient panic.

What was it that justified this expansion of the financial sector since 1980? The obvious answer was that it had grown through the powers of financial innovation, for example, through securitization of loans where it could hold much smaller equity positions than when it originated loans and held them with 100% equity positions in each loan. The creation of derivative securities also permitted expansion of leverage. Securitization and the creation of derivative securities were based on so-called financial engineering. Securitization and the new derivatives were two forms of financial engineering that permitted a bank to do more business with a given amount of its own equity capital. At first this story of growth through technological innovation might sound like a return to the circumstances we saw at the end of the 19th century, with the innovative firms driving weaker ones to the margins or even extinction. It was that elixir of Schumpeterian creative destruction. And the financial institutions were insistent that it was an appropriate parallel. Any regulation of leverage would stifle innovation and thereby hurt consumers in the long run. But the details of the two stories seem remarkably different.

Consider the underlying "technologies." The rise of the industrial sector in the 19th century, starting with the railroads and the telegraph and continuing through the development of steel, oil and then petrochemicals and all sorts of mechanical and electrical machinery, was based upon the engineering that created new technologies which increased physical outputs per person and/or reduced the time that it took to produce such inputs. Did the new financial engineering lead to increased productivity, for example, by squeezing the margins of the inefficient small banks? Or was it more based upon shifting incomes from traditional industries to the financial sector, as the latter took over more and more of a function that had previously been largely within the firms? Clearly, there could be increased efficiencies in either case. But was that all?

Since the US growth rate was not higher following these post-1980 innovations, important questions deserve to be addressed. Was the growth of the financial services sector more a transfer of incomes among sectors than a net gain to society? Were the financial innovations a way to generate more volatility that needed to be insured against, and thus in part a self-generated producer of wealth for those very same financial institutions? Was the new system a way of using financial innovation to extract incomes from non-financial sectors and transfer them to the financial sector? Or was it really a way to increase the aggregate wealth of society? If the latter, where was the evidence?

Of course the economy had become more volatile, and this induced a growth in the market for derivatives, but was this mostly the financial sector creating new opportunities for itself through creating increased volatility, which needed to be insured against? Without attempting answers, we can say that the newly deregulated system resulted in far higher incomes in the powerful firms of the financial sector. As Simon Johnson notes, "From 1973 to 1985, the financial sector never earned more than 16% of domestic corporate profits. In 1986, that figure reached 19%. In the 1990s, it oscillated between 21 and 30%, higher than it had ever been in the postwar period. This decade, it reached 41%. Pay rose just as dramatically. From

1948 to 1982, average compensation in the financial sector ranged between 99 and 108% of the average for all domestic private industries. From 1983, it shot upward, reaching 181% in 2007."[39] (see Fig. E.9)

Unlike in the 19th century, this growth was highly concentrated in the upper income brackets of the financial sector, and was not apparently accompanied by

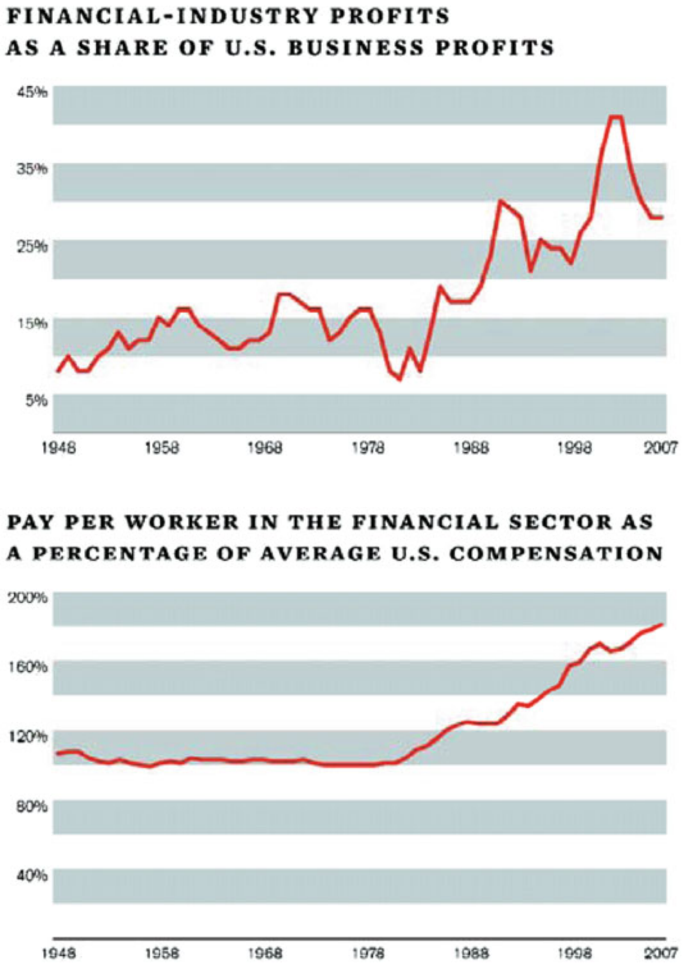

Fig. E.9 Financial industry profits as a share of US business profits; pay per worker in the financial sector as a percentage of average US compensation. Source: Simon Johnson, "The Quiet Coup," *The Atlantic Monthly* (May 2009)

[39] Johnson, "The Quiet Coup."

any overall increase in growth for the US economy. Indeed, when the losses to the US economy for the years 2008–2010 are added up at the end of 2010, it seems quite likely that the most recent 30-year cycle will have been one with a lower growth than its predecessor, with a huge concentration of income in the one sector, from roughly 15% in 1980 to somewhere in the high 30s from 2000 on, while the earnings of average workers, as indicated in Fig. 14.3 (median male earnings), did not apparently improve at all. Was the financial sector creating value added for the US economy, or was it mostly transferring income from Main Street to Wall Street while creating huge risks for society as a whole? Was this an important enough question to study, or was this the kind of question that must not be studied to avoid potentially contentious issues?

Given these imbalances as well as the above story that Volcker, the data, and a burgeoning literature of similar analyses and anecdotes tell, why was nothing done to at least inquire about the roles of the captains of finance and the trillions of dollars of damage that had been inflicted upon American society while a small elite in financial services was reaping one-sided profits? Why were the heads of venerable auto firms summarily sacked, but not the heads of some of the leading pillars in the financial services sector? Was the financial crisis a lesser threat to the US economy? Martin Wolf, a very shrewd observer at *The Financial Times*, thought quite the opposite, as early as January 2008: “I now fear that the combination of the fragility of the financial system with the huge rewards it generates for insiders will destroy something even more important—the political legitimacy of the market economy itself—across the globe. So it is time to start thinking radical thoughts about how to fix the problems.”[40]

Even some of the leadership of the financial sector itself seemed to agree that the system and the sector had failed and that reform was necessary. When not busy paying themselves incentive compensation for several more busy years, some of the best-known leaders finally showed signs of thinking hard about what had happened. Goldman Sachs CEO Lloyd Blankfein was one who saw some issues beyond those facing his own firm: “Much of the past year has been deeply humbling for our industry. People are understandably angry and our industry has to account for its role in what has transpired. Financial institutions have an obligation to the broader financial system. We depend on a healthy, well-functioning system but we failed to raise enough questions about whether some of the trends and practices that had become commonplace really served the public’s long-term interests.”[41] After indicting his industry for its lack of curiosity about how financial services were serving the public interest, Blankfein continued on to suggest reform to the system and the ideology underlying it: “For policymakers and regulators, it should be clear that self-regulation has its limits. We rationalized and justified the downward pricing of risk on the grounds that it was different. We did so because our self-interest in preserving

[40] Wolf, “Why Regulators Should Intervene in Bankers’ Pay.”

[41] Lloyd Blankfein, “Do Not Destroy the Essential Catalyst of Risk,” *The Financial Times*, February 9, 2009.

and expanding our market share, as competitors, sometimes blinds us—especially when exuberance is at its peak. At the very least, fixing a system-wide problem, elevating standards or driving the industry to a collective response requires effective central regulation and the convening power of regulators."[42]

Alas, this recognition by a leader, within the sector itself, came only in early 2009, after the damage had been done, and while the industry was flat on its back. Once it was covered by government guaranteed debts, and thus free to borrow at almost zero cost from government sources, the captains of finance seem to have rapidly lost their zeal for reform.

Why did no one else complain, however? It seems that the long-term damage and distortions did not seem to register with the average American, let alone the policymakers of the time. As Johnson indicates, they bought into the notion that greater leverage would mean greater growth for all, and if Wall Street was doing well then Main Street must also be doing well: "In a society that celebrates the idea of making money, it was easy to infer that the interests of the financial sector were the same as the interests of the country—and that the winners in the financial sector knew better what was good for America than did the career civil servants in Washington. Faith in free financial markets grew into conventional wisdom—trumpeted on the editorial pages of *The Wall Street Journal.*"[43] And, as Johnson also notes, policymakers bought into this rationale as well: "Because everyone was getting richer, and the health of the national economy depended so heavily on growth in real estate and finance, no one in Washington had any incentive to question what was going on."[44]

And yet, inaction, especially on the part of policymakers, was not simply due to a belief in the financial sector or even in an ideology of laissez-faire. It was also deeply grounded in a new power structure that had arisen since the middle of the century, as the political system opened up, effectively permitting greater influence to those with money, and, namely, the financial sector. To borrow from Johnson's words, it was grounded in the power of a new oligarchy in the United States, much like that seen in emerging markets today.[45] As he explains, "elite business interests—financiers, in the case of the US—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them."[46]

Essentially, Johnson is arguing that change will not come without breaking the oligarchy of the financial sector. He advocates such drastic reform as he continues his analogy of the United States with an emerging country plagued by a powerful, entrenched elite class:

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[42] Ibid.

[43] Johnson, "The Quiet Coup."

[44] Ibid.

[45] Ibid.

[46] Ibid.

> The challenges the United States faces are familiar territory to the people of the IMF. If you hid the name of the country and just showed them the numbers, there is no doubt what old IMF hands would say: nationalize troubled banks and break them up as necessary . . . To break this cycle, the government must force the banks to acknowledge the scale of their problems. As the IMF understands . . . the most direct way to do this is nationalization. Instead, Treasury is trying to negotiate bailouts bank by bank, and behaving as if the banks hold all the cards.[47]

If the oligarchy of the financial sector is not broken, Johnson warns, the crisis will simply continue, leading the global and US economies to gradually deteriorate to a point so bleak that the United States would have to act: “Under this kind of pressure, and faced with the prospect of a national and global collapse, minds may become more concentrated.”[48]

Given the data cited throughout this Epilogue, Johnson’s concerns certainly seem plausible. The day of reckoning can be put off by maintaining guarantees on private loans, perhaps for decades, and by creation of additional money by the Federal Reserve, according to the mantra of “whatever it takes.” But as Johnson makes clear, reform requires breaking the oligarchy, and the United States has showed no inclination whatever in this direction in the financial services sector. If its leaders had been treated like their counterparts in the auto sector, this picture might look very different. Whether reform is possible, however, is uncertain.

[47] Ibid.
[48] Ibid.

Appendix
The Capitalist Firm in a Regulated Environment

While markets are the key mechanism for the coordination of economic decisions in a capitalist system, firms are the key vehicle for the mobilization and utilization of resources to generate output, employment, and wealth within those same market economies. The right to mobilize and utilize resources implies the right to exercise power both inside the firm and in external markets. In markets where there are many buyers and sellers, competition limits the powers of individual firms. But if there are only a few suppliers, then each firm has the potential power to influence market conditions, including prices. Within the firm, power is exercised through a hierarchical structure in which the visible hands of managers coordinate the decision-making of subordinates. This hierarchical coordination is, in a sense, the antithesis of the decentralized decision-making that is the strength of markets. Typically, it is also quite undemocratic. Why are private actors allowed to mobilize so much power? What, if anything, do they owe society in return? Should they be obliged to manage for the benefit of the various stakeholders in the firm, or primarily for the benefit of one group, e.g., the shareholder?

From the point of view of the private sector, firms are organized because they provide a legal vehicle for the mobilization, allocation, and administration of resources in search of opportunities for profits. They exist and become large because some technologies, such as the smelting of iron ore to make steel, or the construction and operation of a railroad, require very large-scale operations, far beyond what one individual or a few partners could normally afford. In addition, in relatively underdeveloped areas, such as the United States and Europe before 1900 or even the 1960s, firms with new technologies typically have to organize many aspects of their own supply chain because the relevant industrial markets do not yet exist. These same firms may later have the choice of outsourcing many activities, as has become much more common with declining trade barriers and transport costs. These issues are addressed in Chap. 13, which examines the rise of the large firm in the United States in the 19th century.

Since firms have the right to mobilize power through accumulating the investments of many people that exercise requires the authorization of a political authority. Typically, the investors are given a very broad grant of power to form a corporation that can act as a legal person, yet endure through time even if the particular individuals change. Corporations are usually granted the power to mobilize and control the use of resources through a hierarchical organization, a situation not unlike that of a military commander with the power to mobilize an army that can move forward or change direction on command. Inevitably, the authorization to mobilize and utilize power implies that market actors have the potential not just to provide employment and serve customers, but also to abuse suppliers, customers, and/or employees. In theory, competitors compete away any such market power, reducing market-based returns to the cost of capital; in reality, firms develop strategies to create and protect positive returns.

There are great variations by country in the amount of private power that will be either authorized or tolerated, and variations over time as well. For example, in many countries railroads were initially built and operated by the state, partly because it had the means to finance such large undertakings, partly because this ownership and control would minimize the issue of creating a rival source of power, and partly because the railroads were seen as vital to national defense, as, for example, in France and Germany. In the United States, however, there was great mistrust of public power and two oceans protected the United States from serious military threats. So private firms were permitted to start railroads, and indeed they were given huge land grants to provide them an asset base from which to finance their projects. This put unprecedented power in private hands, on a scale with feudal lords in Europe or elsewhere, and resulted in one or a few railroads dominating state legislatures late in the 19th century, as described in Chap. 13.

How can the public authorities hold large firms accountable for their behavior, when that behavior might adversely impinge on much weaker private parties? Firms can be held accountable by different agents and processes at each of the three levels in the capitalist system, shown in Fig. A.1. For example, there are three forms of accountability at level one. (I have reversed the ordering of the levels in this diagram, with the markets on the top, in order to symbolize the firms as a hierarchy where top management is responsible to its shareholders.) The capital markets are one such source, by the means just described. Additionally, these same capital markets can force a firm into bankruptcy if other means of discipline fail to lead to improved performance. Product markets provide a second form of accountability. Consumers can reject shoddy or overpriced goods. Firms are also held accountable by the labor markets. Employees and their representatives expect fair wages and fringe benefits as well as appropriate working conditions. Otherwise they can exit the firm or, if unionized, implement a strike or slowdown.

The second level of the system provides much more formal monitoring through a variety of regulatory agencies. The mission of these agencies is to ensure that firms do not abuse the powers delegated to them as they act in various markets, including in the larger markets for political power and public opinion. Regulatory agencies typically employ a professional staff that has the power to investigate and, if necessary, prosecute offenders. For example, in the United States, the Federal Trade Commission (FTC) can monitor for possible monopolization of a market, or for lesser abuses of market power. The Food and Drug Administration (FDA) has the right to prohibit the distribution and sale of certain classes of products. The

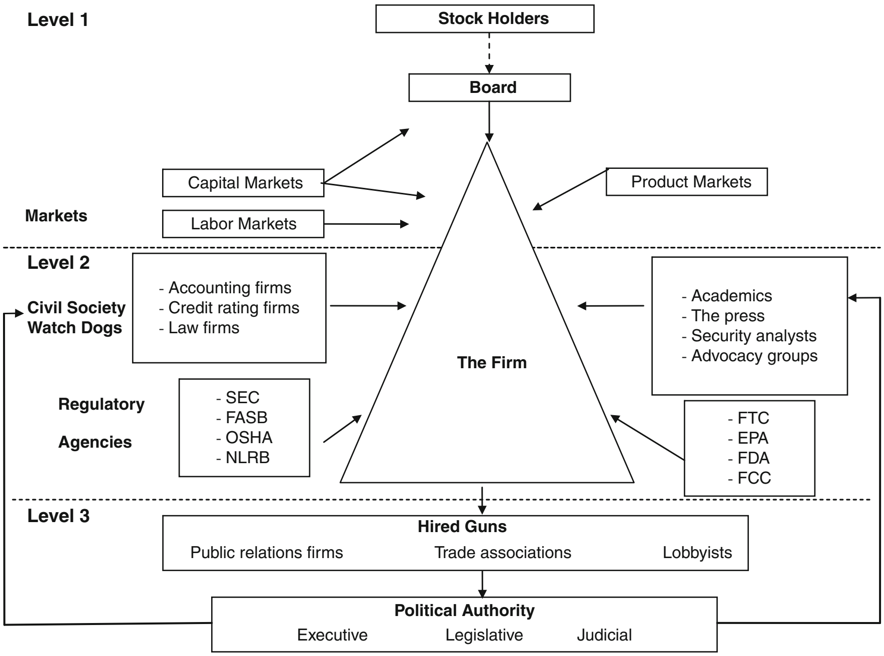


Fig. A.1 The firm in the US capitalist system. Source: Bruce R. Scott

Occupational Safety and Health Administration (OSHA) regulates workplaces to protect employees from unsafe and unhealthy working conditions, while a Pension Benefit Guarantee Corporation (PBGC) protects and insures their pension benefits. The Financial Accounting Standards Board (FASB) sets the rules for the reporting of financial data to investors, and the Securities and Exchange Commission (SEC) enforces these rules and standards in order to protect investors in the capital markets from inadequate or misleading information.

The formal activities of government agencies are supplemented by a number of private sector watchdogs that are grouped as parts of civil society, at level 3. Accounting firms play a quasi-regulatory role when they certify audits of financial statements as in accord with generally accepted accounting practices (GAAP); bond rating agencies evaluate debt securities for their credit-worthiness, again in a quasi-regulatory role; security analysts evaluate firm performance in the search for investment opportunities; and news media perform more general evaluations of how companies are performing, how they are managed, and how they may be acting to shape public opinion in their favor, for example, by lobbying. In addition there are a host of special purpose advocacy groups who monitor firms for possible abuses, where these groups build their own membership and financial support by exposing alleged wrongdoing, a situation which gives them an incentive to create controversy for reasons of their own. Finally, academic institutions also play a watchdog role, developing theories of good management and of the expected performance of different types of firms or firm strategies.

At first sight, Fig. A.1 may seem to place the firm in a position like that of Gulliver in the land of the Lilliputians, i.e., a giant being harassed if not totally tied down by a small army of assorted unfriendly agents. But firms are not without their own powers to protect themselves. Firms have the power to push back against the oversight of any of the regulatory agencies or watchdogs, perhaps co-opting, intimidating, or even emasculating them on occasion. For instance, firms can lobby to try to restrict regulatory oversight by asking the legislature to reduce the budgets of any agencies that are unduly invasive or strict. Indeed, lobbying and public relations agencies give firms the opportunity to try to reshape market frameworks in their own favor even if the result deviates from the interests of society as a whole. Thus, firms can lobby to pay lower taxes, shifting value from consumer-taxpayers to their own shareholders without creating any net gain for society. They can also lobby for protection from product safety responsibilities, for less strict rules of environmental protection, or for less strict protection of their employees' safety and health. Freedom to lobby, both by individual firms and through trade associations, creates another sort of tension within capitalist systems, as it gives firms and industries ways to reshape market frameworks to their own advantage.

No regulatory framework can be expected to be perfect, nor to be revised in a timely fashion as technologies and societal priorities change. Imperfections are likely to be even more apparent in a developing country, where the market frameworks are less firmly established, the problems of modernization more significant, and the various groups representing civil society less developed and less well funded. In addition, longstanding oligarchic relationships may give firms vested interests that they wish to protect, such as the right to continue to pollute the surrounding countryside. Corporate self-restraint could reduce the need for continuous adjustment in the number and detail of the regulations, but self-restraint may entail some reduction in short-term profitability. Self-restraint in exploiting the inevitable loopholes in market frameworks is the essence of social responsibility, yet it has a checkered history and is in itself controversial.

Who really governs a firm, and how, and for what purposes? Some countries have what is known as stakeholder capitalism, where the legal responsibility of the board is for long-term viability of the firm as a member of a community. Shareholder capitalism, in contrast, is premised on the notion that firms, by focusing more narrowly on shareholder interests, are automatically doing what is best for society as a whole. Either of these forms of capitalism has an ambiguity at its very core. Shareholders used to invest for long periods of time, and for their own account. With the deregulation of markets and trading commissions, the duration of the average shareholding in the United States is about 1 year, where it was more like 6 years in the 1960s. Furthermore, shareholders are not normally allowed to nominate directors. Shareholders can make their voices heard in time of crisis, and when some group of investors makes a bid to buy the firm, but in the normal course of events shares are increasingly owned and traded by institutions which are likely to have a much shorter time horizon than the managers of the firm, and different interests from the ultimate investors whose money they manage. The governance process of large firms is thus ambiguous, and incentive compensation can make it more so, as discussed in Chap. 14

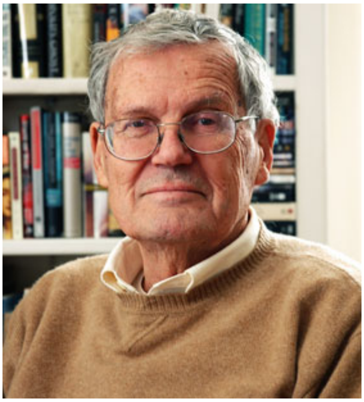
Shareholder capitalism can take on a very aggressive meaning when coupled with the notion that the obligation of management is to maximize shareholder value. Profit maximization or share price maximization to enhance shareholder value inevitably increases the tensions between shareholder interests and those of other groups in society, and it also creates a rationale for top managers to focus narrowly on the interests of wealthy elites who own most of the shares.

Market frameworks, as societal constructs enacted by legislatures, will almost inevitably be imperfect, and they can be made even more imperfect by corporate lobbying. The maximization of shareholder value, in Milton Friedman's perspective, seems to entail that firms can spend the shareholders' money to loosen or distort the regulations, while attributing the societal costs to the irresponsibility of government. In societies that permit huge campaign contributions and equally large budgets for lobbying, ethical guidance that damns firms for extremely modest charitable donations, while assuring them that they may lobby for regulatory relaxation, opens the floodgates wide to abuse of the commons, meaning the abuse of the capitalist framework.

It is essential to the long-run viability of the capitalist system that firms earn more than their cost of capital. However, this is quite different from the notion that the fundamental guiding principle for the firm is to maximize shareholder returns. The former concept establishes a floor, albeit one that may be different for various industries, firms, and national circumstances, while the latter is built around the notion that higher returns are inevitably better so long as they are legal and consistent with ethical customs, however unclear those may be. In reality, a capitalist system has a built-in tension between the freedom needed to exploit opportunities to create value for consumers and shareholders, and the freedom to abuse that same power to corrupt the system for the advantage of a few top people and their shareholders through practices that are contrary to the interests of society as a whole. The price system is a marvelous coordinating device for decentralized decision-making, but it is only as good as the laws and institutions that define the various market frameworks and the regulatory regimes that hold top managers accountable to society in their use of economic power. Absent a moral compass within the firms themselves, capitalism provides ample leeway for the few to abuse the goodwill of the many.

This brief look at the role of the firm in a capitalist society suggests that achieving accountability for firms is a vital aspect of a successful, decentralized system of decision-making. At the same time, it suggests that achieving such accountability on a continuing basis as conditions change is anything but a simple task. As a result, market frameworks can be expected to be continually contested between the firms, the regulators, and other societal interests that are affected. We should expect that some measure of distortion is the rule rather than the exception. Maintaining and modernizing market frameworks in developing countries is, if anything, an even more difficult and contentious task.

About the Author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Bruce R. Scott is Professor Emeritus at Harvard Business School. His particular area of interest is the impact of public policy on the business environment. In the 1960s, he lived in Europe and wrote cases on firms in Switzerland, France, and Sweden, and wrote a book on the French industrial planning system. He took the lead in converting Harvard's required MBA course on the environment for business from one focused on the United States to one focused on the global economy. He has also taught in various executive education programs, as well as a course in the Economic Strategies of Nations.

Professor Scott has participated in the scenario-planning activities of Royal Dutch/Shell, a scenario analysis of the Venezuelan economy, and similar analyses of the prospects for transition in South Africa (1990–1991) and for Luxembourg (1997). In 1991, he was appointed by the US Senate as one of its four representatives on the US Competitiveness Policy Council, an advisory board established by the Trade and Competitiveness Act of 1988.

His previous books include *Industrial Planning in France* (with John McArthur), *U.S. Competitiveness in the World Economy* (with George Lodge), *South Africa: Prospects for Successful Transition* (with Robert S.K. Tucker), and *EUROPE 2012: Globalisation et Cohesion Sociale: Les Scenarios Luxembourgeois.*

Professor Scott holds a B.A. in economics and history from Swarthmore College, and M.B.A. and D.B.A. degrees from Harvard Business School. He is married with three children and three stepchildren and lives in Cambridge, Massachusetts.

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