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Today's Attack upon "Capitalism"

- Critics Have it All Wrong -

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T.S. Eliot

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SED PROFILE, August 2019

Today's Attack upon "Capitalism"

- Critics Have it All Wrong -

First, a brief statement about the US economy and markets. Thereafter, the essay on capitalism.

State of the US Economy: As we expected, US growth has continued to be moderate (with quarterly ups and downs) long after many commentators thought it was "time for a downturn", one precipitated by the trade war President Trump initiated. However, the global slowdown elsewhere in the world, along with declining auto sales and weakness in both manufacturing and in retail sales suggests that US growth may be in the 1% - 2% region over the next six months. It could of course turn negative, but we do not see this yet.

The Market: As for the markets, they have done well enough, boosted by what we view as unfortunate pandering by the Fed. Monetary policy is in a crisis, and the hesitant and somewhat contradictory statements of our new Fed Chairman are not reassuring. Regardless, some of the predictions underlying our "Barbell Strategy" have recently been supported by two important events. First, earnings growth *is* slowing down. Second, the number of share repurchases *is* down from a year ago, as we predicted.

Recall that it was the trio of soaring earnings growth *and* ever-increasing share repurchases *and* falling interest rates that caused the market to rise from 870 in 1981 to 27,200 on the Dow today – *without a bubble valuation.* We believe that this trio of good fortune is over, although interest rates will remain low. Were an economic slowdown to turn into an outright recession, we would expect the Dow to fall to around 21,000.

We now turn to the topic of this ***PROFILE***: capitalism.

Today's Attack on Capitalism

There are increasing signs that faith in capitalism is waning. Reflecting this is the number of politicians on the left and even some on the right who challenge the doctrine that originated in the work of the Scottish moral philosopher Adam Smith. There is no end to the list of woes being laid at the doorstep of capitalism:

o Executive compensation has become a joke, with CEOs often making 360 times the pay of average workers. This contrasts with the situation in 1980 when CEOs earned 42 times as much as the average workers. [These numbers represent average pay ratios for S&P 500 companies.]

o In 1990, the bottom 90% of the American workforce earned 58% of total US personal income. In 2015, that share had dropped to 46.6%. Had the 1980 share been held constant, the bottom 90% of the workforce would have had additional 2015 income of some $11,000 *per household*, or about $1.3 trillion in total.

o Corporate profits have soared from an average 5% of national income to over 10% - causing an equal 5% reduction in labor's share of the pie. [The shares of national income going to labor and capital must equal 100%.]

o The largest contributor to the unprecedentedly high share of profits in national income has been the explosion of "monopoly rents," as we have explained in detail in past ***PROFILES***. These sky-high returns are almost entirely due to the rise of monopolies and oligopolies. These firms, ranging from AT&T and Verizon to Merck and Pfizer and to Facebook and Google, earn rates of return that permit them to buy up and shut down any potential competitors – further boosting their profits.

o The share of Value Added in the economy due to monopoly rents has risen from about 3% in 1980 to 24% today. "Value Added" refers to that 51% of US GDP that is generated by business activity. Thus, the increase in monopoly rents is enormous.

o The weakening of labor's bargaining position is reflected by the decline from some 42% to 8% of the private sector workforce under union protection.

o A surge in outsourcing of good American jobs to Asia and elsewhere has left ever fewer desirable jobs for American workers.

o An ongoing loss of worker protections and benefits further undermined job security. This started with the substitution of 401k retirement plans for traditional defined benefit plans.

o A slowdown in productivity growth has occurred making the plight of workers and the fate of their wages even worse. This slowdown is often blamed on the "greed" of CEOs who utilize corporate profits to buy back shares, a strategy that increases the values of the shares and options held by CEOS. The large buyback of shares and increased dividend payments to shareholders has left less capital available for R&D and growth, a fact underscored by the downward trend of corporate investment.

Part A of this ***PROFILE*** offers a rebuttal to what is claimed about the failure of capitalism. Part B then goes beyond this rebuttal to sketch the nature of an *ideal* social system – a yardstick against which real-world capitalism can be measured.

Part A. A Rebuttal in Defense of Capitalism

To begin with, the above critique of what people *think* capitalism to be is largely true. These beliefs are causing socialist candidates to be listened to, not only in the US but around the world. To appease such criticism, many business people are suggesting that capitalism be "softened". They go along with higher minimum wages. They applaud the shift from shareholder interest to "stakeholder interest" whereby the emphasis on profit growth is dampened. But it turns out that these are bogus remedies that will not improve matters at all.

The problem with today's crisis in capitalism is that almost every woe it is blamed for has little to do with *true* capitalism, but everything to do with today's *bastardization* of true capitalism. It is the *lack* of true capitalism that is behind many of the problems cited above. The purpose of this ***PROFILE*** is to help set the record straight in this regard. In doing so, we can make suggestions as how to improve the status quo, not simply to complain about it. One important means of improving the status quo would be to *restore* true capitalism to its proper place within the larger social system. But this is not the only remedy, as we shall see.

A Definition of True Capitalism

True capitalism amounts to a significant extension of the basic insights of Adam Smith. There are two ways to extend our understanding of his insights. But to begin with, what were his two most important insights? First, Adam Smith intuited the notion that *decentralized* decision-making by people who are anonymous to one another could generate an "efficient" economy. That is, given the labor and material resources available, economic agents would bake the biggest pie it was possible to bake. There would be no waste. No pie thrown into the garbage due to inefficiencies in production.

The second great insight of this philosopher was to recognize that the goal of efficiency required "perfect competition." Consider the market for wool. Suppose there are one million sheep farmers – so many that no subset of farmers could gang up on other farmers and "rig" the market by setting prices. Rather, prices would be set by the "Invisible Hand" of the price system, and no one farmer or large group of farmers could alter the supply=demand price set by the market. As economists say, "prices are taken as given by the Invisible Hand." In such a regime, every single producer is strategically inert: none has any bargaining power at all, as was proved by the Nobel laureate Robert Aumann.

The first way in which it was necessary to deepen our understanding of Smith's insights stemmed from the need to identify the *precise conditions* under which his model worked. This occurred in the mid-1950s when the economists Kenneth Arrow and Gerard Debreu formalized microeconomics. Consider some examples of the conditions they identified. They discovered that consumers must possess the property of "diminishing marginal utility" for goods and services. This simply means that the sixth brownie is a little less satisfying than the fifth, and the fifth is a little less satisfying than the fourth, and so on.

They demonstrated that producers must exhibit the property of "diminishing returns to scale." Consider the copper market. Extracting more and more copper from a mine gets increasingly expensive and less profitable the deeper down a mine is drilled. This property of "decreasing returns" must hold true for all industries. When major industries possess *increasing* returns to scale, as they do now, capitalism faces very serious problems.

Importantly, in an economy satisfying these precise conditions for true capitalism to work, ”excess returns” will be 0% - the sole exception being those excess returns that result from corporate innovation. [To say that excess returns are zero means that competition drives returns down to that level where firms make a competitive, risk-adjusted rate of return on their invested capital, and cover their overhead and interest costs. Any returns above this level are called excess returns.] Also, no monopolies or oligopolies are allowed to exist, as their existence would violate the condition of perfect competition.

Dynamic versus Static Capitalism: The second way in which it proved necessary to extend Adam Smith's insights was to extend his concept of efficiency to economic performance over time – that is, to render it *dynamic*. Most textbook accounts of perfectly competitive efficient economies are *static* in nature. Time plays no role. But capitalism is a theory about optimal savings and investment over time. It has a dynamic dimension. Starting in the late 1950s, scholars such as E. Malinvaud and T. J. Koopmans extended the concept of static efficiency to economic efficiency over time. They hatched the modern theory of *optimal economic growth*, currently known as growth theory. The two leading experts on this subject in recent years have been Robert Solow and Paul Romer, both Nobel Laureates.

To sum up, "true capitalism" refers to an economic system where the preconditions for both static and dynamic efficiency are fulfilled. Today, neither set of preconditions is fulfilled.

The Sorry Condition of Capitalism Today

Suppose that we had lived during the past thirty years under a regime of *true* capitalism. How would things be different today?

(i) There would be no preposterous executive compensation. For with zero "excess returns," there would be no slush with which to pay out uncompetitive salaries. Doing so would bankrupt the firm.

(ii) The rise of ever larger shares of corporate profits due to "monopolistic" or "oligopolistic" rents could not have happened. This is because perfect competition guarantees zero excess returns, and hence zero monopoly rents.

(iii) Had there been no increase in monopoly rents, the mushrooming number of billionaires associated with monopolies and oligopolies would have been small. As a result, the distribution of income and wealth would have been much flatter than it became.

(iv) Had the condition of perfect competition held true, the share of national income going to labor and income would have remained unchanged in the last thirty-five years, rather than rising spectacularly for capital, and falling for labor.

(v) The bargaining power of labor would have been reduced less than it has been. For it is well known that, the greater the share of companies earning monopolistic rents, then the greater the loss of bargaining power on the part of labor. This makes intuitive sense: for the smaller the number of competing firms there are, the harder it is for workers to bargain by playing one firm off against another. Economists refer to this property as "increasing monopsony."

(vi) Labor's plight would have been lessened since outsourcing jobs to China would have been smaller had US presidents stood up to China and refused to buy its goods unless it became willing to trade "fairly" in the sense of the World Trade Organization covenants. True capitalism in an international context requires that *all* players play by the same rule book. But China continued to break all such covenants, and cheated in any way possible. And the powers that be permitted China to do so without exacting a price in return. Among other things, the advantages that China enjoyed increased the appeal for US firms to outsource more jobs than they would or should have done had proper policies been in place.

(vii) The alleged decline in productivity would have been less than it has been, as studies have shown that the pressure for research and innovation is strongly correlated with perfect competition. But even so, the belief that productivity has slowed down can be challenged on fundamental grounds.

Suppose we adjust the official inflation numbers of the last two decades downward by 1.3% annually, as recommended by Harvard's late Martin Feldstein and MIT's David Autor. Then there has been no decline at all in corporate productivity. For productivity is simply growth of *nominal* GDP minus the official inflation rate – assuming a constant workforce size. If the same number of workers produces 2% more output, then we say that labor productivity has increased 2%. We have explained in the past why we feel Feldstein and Autor to be correct in their analysis of why inflation has been overstated in recent years.

The much deeper problem underlying both the measurement of inflation and even of GDP lies in the shift from an economy where growth has been measured *solely* in terms of growth in output (e.g., number of cars produced), to an economy characterized by an explosion of quality and variety of output – not quantity. The system of national accounts established by Simon Kuznets and others back in the 1920s was never designed to measure any increase in the quality of goods and services.

(viii) The "decline in wage growth" story would have been much less important had true capitalism prevailed. Labor would have had more bargaining power had cartels and oligopolies not arisen, and labor's share of national income would have been higher reflecting a lower level of excess returns by corporations. When the more important issue of rising living standards is taken into account, the decline in wage growth story is even more problematic. While it is absolutely correct that the explosion of monopoly rents and pricing power has deprived workers of over 5% of national income, as documented above, and while it is true that inflation-adjusted wage growth has been quite flat (but not if the official inflation numbers are adjusted downward), the increase in living standards made possible in the *corporate* sector has been impressive.

In past ***PROFILES***, we have explained how this increase can be measured, using an argument developed by the economists Kenneth Arrow and Paul Samuelson. Briefly, ask people to choose between their consumption bundle bought in 1970 with1970 wages, and their bundle today bought with current wages. Virtually everyone prefers their bundle today, and by a lot. Imagine life without Thai food or i-phones or Viagra! The *magnitude* of this preference gap is the proper measure of *how much* living standards have risen over time.

However, while this now-versus-then preference ordering is true of private sector goods and services, it is *not* true of government services where negative productivity prevails. Consider state governments: despite rising fees and taxes imposed on taxpayers, the security of workers' pensions has declined, and roads, schools, bridges, and tunnels deteriorate daily.

And then there is healthcare! US healthcare problems are usually laid at the doorstep of greedy insurance company and doctors. Yet the real problem confronting healthcare in the future will be a *large shortage of doctors* and related professionals. Government has been complicit with the medical profession in failing to use its great bargaining power to increase rapidly the supply of doctors, as well as to raise their productivity. The ratio of acceptance to applications to medical schools has declined to a point where it is virtually impossible for good students to become a doctor, despite the desire of millions of students to become one.

As I have proven mathematically (see Appendix B of my book *American Gridlock)*, the only solution to the US healthcare crisis that will provide universal coverage *and reduce the share of GDP accounted for by healthcare expenditures* is to increase the supply of doctors and healthcare services *much faster* than the future growth in demand. [More formally, the supply curve must shift outward faster than the demand curve, and for a long time.] A veritable Marshall plan is necessary to do so, with medical schools ordered to triple enrollment within ten years, and students relieved of all debt as is now true of NYU medical school.

To conclude, capitalism alone should not be blamed for the angst besetting many Americans. Dysfunctional government is every bit as much to blame.

How to Rectify these Problems

The principal policy implication of today's bastardized capitalism is to attempt to return to the capitalism of the textbook – in particular towards far more competitive markets. But is such a return possible, or is it futile? To begin with, true capitalism was never anything other than an ideal. In particular, perfect competition was an ideal. Nonetheless, it is not futile to return *part way* to this ideal. The reason why lies in the property of "continuity" that market economies exhibit. This is the property that, if you deviate from the textbook ideal a bit, the performance of the economy suffers a bit - not a lot. But the larger the deviation, then the greater the failings of real-world capitalism will be.[1]

In this regard, every effort should be made to repeal the growth of cartelization and oligopoly power that has surged in the past three decades. Officials should break up anti-competitive monopolies and oligopolies, enforce anti-trust laws rigorously, and permit far fewer mergers and acquisitions. And as we argue below, taxes should be raised significantly, not on corporations *per se,* but rather on any corporation's "excess returns" that accrue from lack of competition.

The Problem of Increasing Returns: However, there is a very deep issue that makes it difficult to return to a much more competitive economy. Recall from the Introduction above that one of the prerequisites of true capitalism was the condition of "decreasing returns to scale" – as in the case of mining copper. Technological change is now creating more and more industries with *increasing* returns to scale - a phenomenon that is not due to evil capitalists. Rather, it is due to those "network effects" whereby a firm can extend its services to millions more customers with virtually no investment costs at all. Google can develop a new app, and then distribute it to millions of new users – getting the same advertising fees "per hit" as usual – yet pay virtually nothing to do so.

As we have explained in the past, these increasing returns (monopoly rents) in turn give rise to ever more monopsonies and monopolies and oligopolies. These in turn give rise to even greater excess returns. Labor is impacted negatively as its bargaining power is reduced even more. And profits as a share of GDP keep rising, whereas labor's share keeps falling, etc.

[1] This "continuity" discovery resulted from the famous Arrow-Hurwicz analysis of the stability of an economic equilibrium, and in particular from the discovery that an equilibrium is a topological "attractor".

The problem, of course, is that Congress does not have the power or ability to repeal the change in the nature of corporate production functions – the change that explains *why* increasing returns are more prevalent. So instead, governments are introducing new ways of increasing taxes on companies with monopoly rents. France has even decided to tax *revenues*, not profits, which is unprecedented. But many of these alleged solutions are problematic.

A Remedy: In principle, here is what ought to happen: divide into two parts the nature of a firm's total revenue. The first portion will be revenue which is generated by operating in truly competitive markets. The second portion will consist of revenues generated by operating in uncompetitive, high-rate-of-return markets. The first portion of revenue should be taxed at normal corporate tax rates.

The second portion, however, should be taxed at much higher rates – the rates applicable to monopolistic returns. The underlying principle here is that the after-tax profits of such firms should be what they *would* have been had there been perfect competition – with one exception. True capitalism allows for excess returns in the case where producers innovate and are granted a monopoly for several years. In the case of drug patents, companies might get a seven year window for charging a large amount for a new drug. But after this window expires, generic competition takes over and prices fall.

However, the increase in taxation on monopoly rents cannot be excessive. For it is important to *reward innovation* and inspire future R&D and investment. Innovation is the root cause of rising living standards, the most important capitalist virtue of all.

The much higher corporate tax revenues that would result from taxing excess returns would be repaid to laborers and consumers in general – thus evening out the score.

This split-the-revenue policy could be a remedy not only for high tech companies generating excess returns, but also for many more "ordinary" companies. Consider the rise of monopoly profits in the drug and communication sectors. There were once twelve "Baby Bells" when AT&T was broken up back in 1981. The hope was that there would be a lot of competition in the communications sector. But now, Verizon and AT&T dominate the industry. Both have increased pricing power, and much higher returns than before. Government should not only impose taxes upon the profits earned in their noncompetitive sectors, but should also proceed to prevent further mergers, and break up many of today's combines. Every effort must be made to restore competition.

The same is true in the drug industry. Where there were once at least eight market leaders, now we have Merck and Pfizer. And their profits have soared. In his new research, Mordecai Kurz at Stanford has shown a large share of today's sky-high monopoly rents come equally from the high-tech sector and from traditional industries that have become increasingly less competitive, with ever higher profits.

Part B: Toward an Optimal Economic System

To the extent that many Americans are frustrated with life today, and with the alleged end of the American dream, the failings of capitalism are only one source of growing discontent. Equally important is the failure of the government sector of the economy. In taking government malperformance into account, we are motivated by the fact that citizens want not only a good economy, but also a good social system.

In a recent ***PROFILE***, we reviewed the important work of the Nobel laureate Leonid Hurwicz on what is meant by an *optimal social system.* While citizens want a productive economy that raises living standards over time, they also want political stability, the rule of law, human rights protection, "fair shares" of the pie (justice in distribution), and decisional and informational decentralization (aka freedom and privacy).

This last desideratum is less well known than the others cited, but it is important. It refers to the freedom people have to choose what they want for dinner, and to be able to go buy it whenever they wish to do so. No one else need know what their preferences or choices are. And no "permission slips" are required from government officials for people to buy what they want. While such decentralization is possible under a capitalistic market system, it is *not* possible under a socialist central planning system. Yet as late as 1945, many socialist economists believed in central planning more than they did in in capitalism. The subsequent work of Hurwicz and others proved formally how mistaken they were.

While a return to textbook capitalism would improve the performance of the economy, and the status of labor versus capital, a reformation of government would do at least as much to improve life. For citizens' complaints are not so much with the private sector, but with the abject inefficiency of the government sector – whether nationally, or at the local level. Thus, citizens rate highly their new cars and products and services – the output of the private sector. The reason why is not surprising: the incentive structure within capitalism is such that companies *must* forever improve their products because, if they do not, someone else will. There is accountability.

Conversely, governments are accountable to no one, and bureaucrats are famously "indifferent" to those they regulate and govern. They cannot be fired or even reprimanded in many cases, and they face no competition

> *Consider the abject failure of government to control municipal labor unions currently bankrupting city after city; the failure to tax and spend in a way that avoids an ever-growing debt burden on tomorrow's young; the failure to limit leverage in the financial sector – leverage in the housing and financial sector that was largely responsible for the global financial crisis of 2008-2011; the failure in spending taxpayers' monies to produce a mix of "public goods" that benefit the people at large rather than members of those special interest groups that fund politicians' reelection; the failure to stand up to thugocracies like China that trade unfairly in every sense; and finally and perhaps*

most important, the failure to stop a shocking deterioration of public education. US test scores in math were 3rd on earth around 1950, whereas today they rank 37th. Businesses need skilled workers, but cannot find them. Their scarcity is due to the system of public education and not to the behavior of businesses.

"Stakeholder" Nonsense: There is an allied point that should be made in this context. Critics of capitalism often suggest that corporations should focus less on profit maximization, and more on "stakeholder interests." This certainly sounds good. But it is wrong. Businesses will not produce good economic outcomes and rapid growth *unless they <u>only</u> focus on profit maximization.* This is a mathematical requirement for the *existence* of Adam's Smith's Invisible Hand, and for economic efficiency. Firms cannot effectively maximize two or more variables at once, as they would have to do in serving multiple stakeholders.

Rather, critics should lean on *non-business* sectors like government to solve many of the problems that are frustrating citizens. Companies should have nothing to do with pursuing these social goals. Having them do so is a cop out on the part of government, and it dilutes corporate efforts to do what they should be doing: competing.

In short, a division of labor is called for whereby firms do their own thing, and government does its own thing.