Reinventing Capitalism

Taking it to its next phase.

BY DANI RODRICK

Capitalism is in the throes of its most severe crisis in many decades. A combination of deep recession, global economic dislocations, and effective nationalization of large swathes of the financial sector in the world's advanced economies has deeply unsettled the balance between markets and states. Where the new balance will be struck is anybody's guess.

Those who predict capitalism's demise have to contend with one important historical fact: capitalism has an almost unlimited capacity to reinvent itself. Indeed, its malleability is the reason it has overcome periodic crises over the centuries and outlived critics from Karl Marx on. The real question is not whether capitalism can survive—it can—but whether world leaders will demonstrate the leadership needed to take it to its next phase as we emerge from our current predicament.

Capitalism has no equal when it comes to unleashing the collective economic energies of human societies. That is why all prosperous societies are capitalistic in the broad sense of the term: they are organized around private property and allow markets to play a large role in allocating resources and determining economic rewards. The catch is that neither property rights nor markets can function on their own. They require other social institutions to support them.

So property rights rely on courts and legal enforcement, and markets depend on regulators to rein in abuse and fix market failures. At the political level, capitalism requires compensation and transfer mechanisms to render its outcomes acceptable. As the current crisis has demonstrated yet again, capitalism needs stabilizing arrangements such as a lender of last resort and counter-cyclical fiscal policy. In other words, capitalism is not self-creating, self-sustaining, self-regulating, or self-stabilizing.

The history of capitalism has been a process of learning and re-learning these lessons. Adam Smith's idealized market society required little more than a "night-watchman state." All that governments needed to do to ensure the division of labor

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was to enforce property rights, keep the peace, and collect a few taxes to pay for a limited range of public goods.

Through the early part of the twentieth century, capitalism was governed by a narrow vision of the public institutions needed to uphold it. In practice, the state's reach often went beyond this conception (as, say, in the case of Otto von Bismarck's introduction of old-age pensions in Germany in 1889). But governments continued to see their economic roles in restricted terms.

This began to change as societies became more democratic and labor unions and other groups mobilized against capitalism's perceived abuses. Anti-trust policies were spearheaded in the United States. The usefulness of activist monetary and fiscal policies became widely accepted in the aftermath of the Great Depression.

The share of public spending in national income rose rapidly in today's industrialized countries, from below 10 percent on average at the end of the nineteenth century to more than 20 percent just before World War II. And, in the wake of World War II, most countries erected elaborate social-welfare states in which the public sector expanded to more than 40 percent of national income on average.

This "mixed-economy" model was the crowning achievement of the twentieth century. The new balance that it established between state and market set the stage for an unprecedented period of social cohesion, stability, and prosperity in the advanced economies that lasted until the mid-1970s.

This model became frayed from the 1980s on, and now appears to have broken down. The reason can be expressed in one word: globalization.

The postwar mixed economy was built for and operated at the level of nation-states, and required keeping the international economy at bay. The Bretton Woods-GATT regime entailed a "shallow" form of international economic integration that implied controls on international capital flows, which Keynes and his contemporaries had viewed as crucial for domestic economic management. Countries were required to undertake only limited trade liberalization, with plenty of exceptions for socially sensitive sectors (agriculture, textiles, services). This left them free to build their own versions of national capitalism, as long as they obeyed a few simple international rules.

The current crisis shows how far we have come from that model. Financial globalization, in particular, played havoc with the old rules. When Chinese-style capitalism met American-style capitalism, with few safety valves in place, it gave rise to an explosive mix. There were no protective mechanisms to prevent a global liquidity glut from developing, and then, in combination with U.S. regulatory failings, from producing a spectacular housing boom and crash. Nor were there any international roadblocks to prevent the crisis from spreading from its epicenter.

The lesson is not that capitalism is dead. It is that we need to reinvent it for a new century in which the forces of economic globalization are much more powerful than before. Just as Smith's minimal capitalism was transformed into John Maynard Keynes' mixed economy, we need to contemplate a transition from the national version of the mixed economy to its global counterpart.

This means imagining a better balance between markets and their supporting institutions at the global level. Sometimes, this will require extending institutions outward from nation states and strengthening global governance. At other times, it will mean preventing markets from expanding beyond the reach of institutions that must remain national. The right approach will differ across country groupings and among issue areas.

Designing the next capitalism will not be easy. But we do have history on our side: capitalism's saving grace is that it is almost infinitely malleable. ◆

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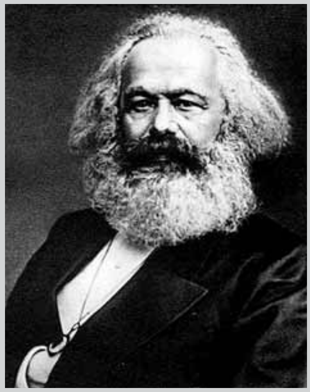
—D. Rodrik



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