

07-037

# **The Political Economy of Capitalism**

**Bruce R. Scott**

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#07-037

## Abstract

Capitalism is often defined as an economic system where private actors are allowed to own and control the use of property in accord with their own interests, and where the invisible hand of the pricing mechanism coordinates supply and demand in markets in a way that is automatically in the best interests of society. Government, in this perspective, is often described as responsible for peace, justice, and tolerable taxes.

This paper defines capitalism as a system of indirect governance for economic relationships, where all markets exist within institutional frameworks that are provided by political authorities, i.e. governments. In this second perspective capitalism is a three level system much like any organized sports. Markets occupy the first level, where the competition takes place; the institutional foundations that underpin those markets are the second; and the political authority that administers the system is the third. While markets do indeed coordinate supply and demand with the help of the invisible hand in a short term, quasi-static perspective, government coordinates the modernization of market frameworks in accord with changing circumstances, including changing perceptions of societal costs and benefits. In this broader perspective government has two distinct roles, one to administer the existing institutional frameworks, including the provision of infrastructure and the administration of laws and regulations, and the second to mobilize political power to bring about modernization of those frameworks as circumstances and/or societal priorities change. Thus, for a capitalist system to evolve in an effective developmental sense through time, it must have two hands and not one: an invisible hand that is implicit in the pricing mechanism and a visible hand that is explicitly managed by government through a legislature and a bureaucracy. Inevitably the visible hand has a strategy, no matter how implicit, short sighted or incoherent that strategy may be.

## The Political Economy of Capitalism<sup>1</sup>

Microeconomics is the study of how markets – the usual defining institution of capitalism – coordinate decentralized decision making through a price mechanism to bring supply and demand into equilibrium. In this time-tested perspective, capitalism is a largely self-regulating economic system in which the proper role of government is limited to providing certain basic public goods and services at low cost. Harvard Professor Gregory Mankiw, the author of a leading economics textbook and former Chairman of the President's Council of Economic Advisors, recently reminded readers of the *Wall Street Journal* of this point of view, claiming: "Adam Smith was right when he said 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.'"<sup>2</sup> Smith's explanation for this minimalist role for government was derived from his seminal insight that the pricing mechanism would coordinate the actions of private actors so as to achieve socially optimal outcomes. Or, in Smith's words: "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."<sup>3</sup>

However, if market prices are to coordinate the actions of economic actors so that they spontaneously maximize the revenues for society as well as for individuals, then those market prices must reflect true societal costs and benefits. While markets may well reflect such costs and benefits, there are certain well known situations where they fail to do so. Externalities, where certain costs and benefits are not fully included in the market framework, are the most immediate exception to Smith's assumption. Externalities reflect imperfections in the laws and regulations that make up the market frameworks. These imperfections cannot legitimately be corrected by the economic actors themselves; the corrections must be made by a political authority, i.e., government. Furthermore, any framework must be modernized periodically in light of changing conditions and changing societal priorities, and this again requires government. Unless the market frameworks are appropriately adjusted, including as circumstances change, then there can be no assurance that the maximization of individual incomes approximates a similar outcome for society. To say that little is required from government but peace, easy taxes and tolerable administration is to overlook the essential role of government in providing the legal and regulatory frameworks that are essential to capitalism. It reduces the study of capitalism to the analysis of

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<sup>1</sup> Bruce R. Scott, Chapter 2, *Capitalism, Democracy and Development*, June 27, 2006.

<sup>2</sup> Adam Smith, as favorably cited by Gregory Mankiw, *The Wall Street Journal*, January 3, 2006.

<sup>3</sup> Adam Smith, *Wealth of Nations*, Oxford World Classics, pages 291-292.

how markets operate in a static context that has assumed away the regulatory and political issues.

This chapter aims to introduce the political economy of capitalism in order to take note of two modes of governmental intervention, direct and indirect, and to highlight two differing roles of government, administrative and entrepreneurial. The chapter begins with an austere definition of capitalism which calls attention to the idea that capitalism is a socio-political system as well as one that is economic. I will enhance this definition to include the notion that capitalism is an indirect system of governing an economy wherein various economic actors are allowed to compete to serve the needs of consumers according to a set of laws and rules, and where the ensuing competition serves to induce the mobilization of human energy and talent as well as other resources for the benefit of society as well as the economic actors themselves.

Organized sports provide a useful analogy through which to gain insights on capitalism. Organized sports may be seen as having a three-level system of governance, through which a political authority delegates the rules and regulations that structure the game itself. A capitalist society can be broken down into a similar structure, in which a political authority mobilizes resources to provide and administer the infrastructure that facilitates and structures economic activity. Finally, firms, like sports teams, compete within this structure. After presenting a three level model of capitalism I will look in more detail at each of these levels to identify some of the key organs of a capitalist system.

In order to illustrate the political and administrative roles of government in a capitalist system, I present three metaphoric market frameworks to show how they can be shaped or tilted for reasons of policy. I flesh out these ideas with two examples of product markets that have been shaped for policy reasons, and then an example from the factor markets (for labor). In conclusion, I suggest that government plays an active and essential role in a well-functioning capitalist economy, and not one that is either passive or peripheral.

### **What is Capitalism?**

Capitalism is a system of governance for economic affairs that has emerged in different settings and continues to evolve over time. As a consequence it evades simple definition. *The Macmillan Dictionary of Modern Economics* defines capitalism as a:

Political, social, and economic system in which property, including capital assets, is owned and controlled for the most part by private persons. Capitalism contrasts with an earlier economic system, feudalism, in that it is

characterized by the purchase of labor for money wages as opposed to the direct labor obtained through custom, duty or command in feudalism... Under capitalism, the price mechanism is used as a signaling system which allocates resources between uses. The extent to which the price mechanism is used, the degree of competitiveness in markets, and the level of government intervention distinguish exact forms of capitalism.<sup>4</sup>

This austere definition identifies capitalism as a social, political, and economic system that succeeded feudalism based upon recognition of the rights of private parties to choose how to employ their labor and capital in markets as indicated by market prices instead of tradition. It recognizes the price mechanism as its key coordinating device instead of command and control, and suggests that capitalist systems are distinguishable from one another based upon the extent and nature of governmental interventions and the competitiveness of their markets.

However, this definition offers only a very brief introduction to the notion of capitalism as a system. It does not, for example, distinguish between direct and indirect modes of governmental intervention nor its administrative and entrepreneurial roles. Governments may intervene directly in markets through such actions as seizing land by eminent domain or nationalizing a firm; alternatively, they may intervene indirectly by altering the institutional foundations in which market transactions take place, e.g., altering the size, shape, or location of a market, or altering the rights and responsibilities of various classes of economic actors, the rules of accounting, and so on. Government's roles and modes of intervention can be shown in matrix form as in Figure 2.1

Figure 2.1: Governmental roles and modes of intervention

Roles	Modes of intervention	
	Direct	Indirect
Administrative	Operate SOE	Enforce laws & regulations Maintain infrastructure
Entrepreneurial	Take property Buy/sell/grow SOE	Pass new laws Issue new regulations Build new infrastructure

Government's indirect mode of intervention in the system may be invisible to the untrained eye, but this is in fact its crucial mode. Price signals that are transmitted through markets can coordinate the actions of economic actors,

<sup>4</sup> *Macmillan Dictionary of Modern Economics*, 3<sup>rd</sup> Ed., 1986, p. 54.

without the need for plans or orders from government, but there are no formal markets without regulations and infrastructure, and no legitimate regulations or infrastructure unless they have been created, maintained, legitimated and, if need be, modernized by a political authority. Furthermore, the definition gives no indication that government has quite different roles in capitalism, one largely administrative in assuring the maintenance of the existing system, and one entrepreneurial, in mobilizing power to achieve legislative authorization to make changes, whether in laws, regulations or the provision of such public goods as infrastructure, the police force, schools or public health system. Figure 2.1 gives a more complete sense of the roles of government and its modes of intervention. In this chapter and the next I will give examples from each of the four quadrants to illustrate the various ways in which governmental action is essential to an effective capitalist system.

Capitalism, as I define the term, is an indirect system of governance based on a complex and continually evolving political bargain in which private actors are empowered by a political authority to own and control the use of property for private gain subject to a set of laws and regulations. Workers are free to work for wages, capital is free to earn a return, and both labor and capital are free to enter and exit from various lines of business. Capitalism relies upon the pricing mechanism to balance supply and demand in markets; it relies on the profit motive to allocate opportunities and resources among competing suppliers; and it relies upon a political authority (government) to establish the rules and regulations so that they include all appropriate societal costs and benefits. Government and its agents are held accountable to provide physical security for persons and property as well as the laws and regulations. Capitalist development is built from investment in new technologies that permit increased productivity, where a variety of initiatives are selected through a Darwinian process that favors productive uses of those resources, and from the periodic modernization of the legal and regulatory framework as indicated by changing market conditions and societal priorities. Capitalist development requires that government play two roles, one administrative, in providing and maintaining the institutions that underpin capitalism, and the other entrepreneurial, in mobilizing power to modernize these institutions as needed. Capitalism contrasts with earlier economic systems characterized by forced labor, self-sufficiency, barter, and/or reciprocal relationships based upon family, tribe, or locally known relationships. It also contrasts with more recent systems where governments have acted directly through ownership and/or central planning to control of the use of resources.

Government's mode of intervention in a capitalist system is primarily indirect: it creates, legitimates, administers and periodically modernizes the various market frameworks that spell out the conditions in which the economic actors may acquire and employ capital and labor to produce, distribute, and sell goods and services. Accordingly, economic actors receive the right to use their power in competition with others, subject to prevailing laws and regulations. The market frameworks can have quite different policy priorities, from protecting the status quo to the promotion of growth and development, from protecting

consumers to protecting producers, and from protecting labor to protecting capital. 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. Thus, this indirect system of governance inevitably embodies a strategy, though this strategy is often largely implicit rather than overt and created gradually over time rather than as a grand plan.

While successful capitalism depends upon the granting of power to private actors to enter, compete in, and exit from markets, it also depends upon the state's power to restrain the private actors so that they do not abuse these powers. To be legitimate as well as productive, private economic actors must be bound by the rule of law, and this rule of law must be backed by the coercive powers of the state. The powers of the state are employed to restrain the private actors from breaking the rules and, if need be, to settle disputes. Successful capitalism is contingent upon a state monopoly of coercive powers.

However, the state's monopoly of legitimate coercive power implies that it has the power to tyrannize its subjects. As a result, successful capitalism also depends upon the creation of checks and balances established through the structuring of the state's 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. 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. I explore the political aspects of capitalist governance in the next chapter.

Capitalist systems typically rely on the state to make direct provision of certain public goods, including highways, schools and law enforcement, as well as to refrain from the temptation to own, operate, or directly control the economic actors. 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 referee. This puts state agents in roles that conflict—for example, as a regulator and as player that need not be subject to the discipline of the markets. There are times when states may play both roles, as in the case of a national emergency or natural monopoly, but it is best if these interventions are for reasons of state, e.g. national security. If direct interventions are widespread and/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.

## *Organized sports as an analog to capitalism*

Capitalism involves a very complex set of relationships, where many actors have power, and each has the capacity to influence how the system works. At the same time it is fundamentally different from any mechanical system in that its components have regenerative powers and their relationships continue to evolve through time. Thus, it is more usefully seen as a system that is organic or social than one governed by rigid laws like physics.

Organized sports provide a useful analogy to a capitalist economy. The comparison can be helpful because organized sports are smaller, simpler systems and therefore more easily understood as totalities. Organized sports also evolve, but typically at a much more measured pace than the dynamic sectors of a capitalist economy. Most people have observed one or more organized sports and are familiar with competition in a regulated context. Thus they can distinguish between a contest with rules and referees and an un-refereed contest, which can deteriorate into a free-for-all. While there are important similarities between organized sports and capitalism, we need to be aware of some differences as well; these differences between capitalism and organized sports will allow us to highlight distinct characteristics of the former.

All organized sports can be understood as three-level systems, as suggested in Figure 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. However, organized sports typically 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, 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.

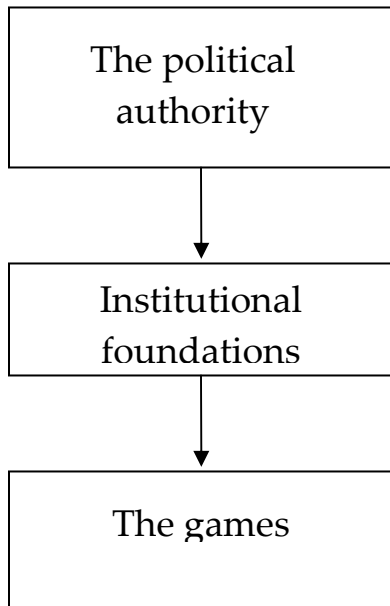
The infrastructure that guides the first level game, then, is created and maintained by the administrative and regulatory officials who comprise the second level. More specifically, these agents demarcate the field, specify the rules of play and the scoring system, and monitor the play. These agents organize and legitimate the competition and ensure that it is carried out on a level playing field, with no unfair advantages permitted.



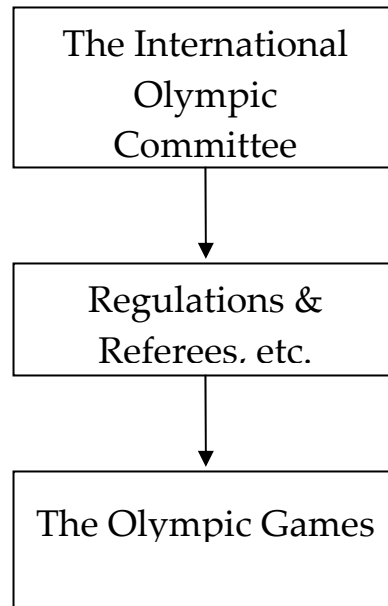
But how do these institutional foundations arise and achieve legitimacy? In organized sports—as in capitalism—a third level is required to complete the system. It is comprised of a political authority with the power to decide on the rules, i.e., who is eligible to compete, the time and location of the 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 a few teams to dominate the sport year after year.<sup>5</sup>

**Figure 2.2. Organized sports, including the Olympics, operate on three levels**

Organized Sports



The Olympics



The Olympics are perhaps the oldest of organized sports, and they are organized as illustrated above. Olympic competition is authorized by the International Olympic Committee (IOC), a self-selected group which meets periodically to decide the time and location for the next competition, the countries that can participate, and the different sports that are to be recognized in the competition. Subordinate political authorities establish the rules and hire the judges to monitor competition. Professional sports, such as international football (“soccer” in US terms) or US professional football are organized much the same way, the former under the authority of the International Amateur Football

<sup>5</sup> 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 which they directly serve.

Federation (FIFA) and the latter under the auspices of the National Football League (NFL).

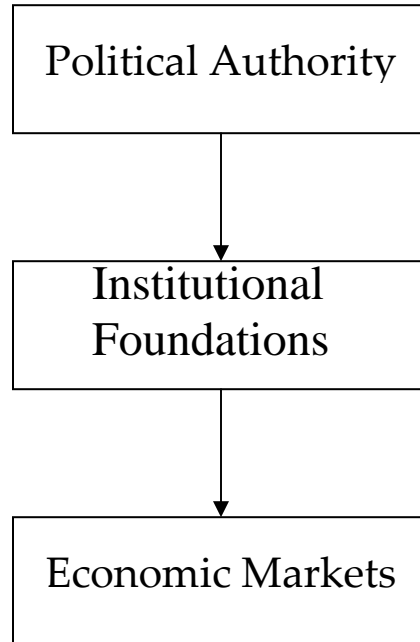
In sports, as indeed in capitalism, political authorities play two distinct roles: one administrative, in maintaining the existing system of playing fields and enforcing the existing rules, and the second entrepreneurial, in mobilizing power to win the needed votes in the legislature in order to admit 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 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 much like 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.

### **Capitalism as a three level system**

Capitalism, too, can be viewed as a three level system, as suggested in Figure 2.3. On the first level—the markets—, firms compete to secure their labor and capital as well as to serve their customers. The second level consists of the basic institutional foundations, including physical and social infrastructure; physical infrastructure includes, among other things, transportation and communications, and social infrastructure includes the educational, public health, and legal systems. In addition, the second level consists of the agents of the state who enforce the rules and regulations, including specialized regulators who oversee behavior in certain industries, such as those that deal with food and drugs or transportation, and those who protect societal resources such as the physical environment or safety in the workplace. The third level consists of a political authority—typically one with specialized functions such as executive, legislative, and judicial branches. In turn, a set of political institutions connect the political authority to the political markets (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.

**Figure 2.3. Capitalism as a three level system**



Thus far I have argued that organized sports and capitalism are comparable systems that operate on three levels. But while there are many similarities between organized sports and capitalism, there are some crucial differences, most of which stem from fundamental differences in the purpose of the respective systems. The purpose of organized sports is to facilitate periodic competition among athletes, whether as individuals or in 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 season or year. 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, which acts under an antitrust exemption, and thus has sovereignty over its sporting league, like a state. New leagues can be organized, but each has its own jurisdiction.

Capitalism is designed to promote the productive use of societal resources in order 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 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.

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.

The concept of the level playing field is used in capitalism as in sports, but 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.

As referenced in the introduction to this chapter, prices coordinate decisions in terms of supply and demand for all manner of goods and services. In addition they coordinate supply and demand factor markets such as for labor, capital, technology, and, most recently, knowledge.<sup>6</sup> This suggests that we need a more detailed model of capitalism that recognizes different types of markets and the roles of various economic actors. And it also suggests that we need a model that adds other elements to each of the levels in the system.

### Level One: The Structure and Operations of Markets

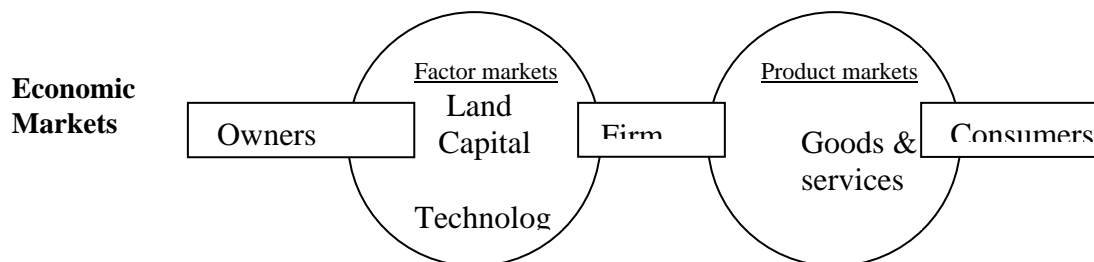
Economic markets are of two distinct types: product markets and factor markets; the two are necessary complements. Product markets bring producers and consumers together. Factor markets bring various suppliers of labor and capital together with producers of goods and services. These archetypal markets are shown schematically in Figure 2.4.

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<sup>6</sup> Cite Warsh here, on the new trend to seeing productive factors as people things and ideas.

Figure 2.4

## The Capitalist System: Level One



Source: Bruce R. Scott

Figure 2.4 identifies the principal economic actors as factor owners, firms, and consumers, and it calls attention to the distinction between factor markets and those for products. It sets the stage for the familiar graphs of micro-economics that show how prices coordinate the forces of supply and demand to achieve equilibrium. In a quasi-static perspective firms produce more or fewer goods for sale depending upon expected prices; in a longer term perspective they compete to improve their products and services and their internal operating efficiency. As they compete they achieve gains in productivity that benefit society as well as the respective economic actors.

A much more refined view of how markets operate has been developed using the industrial organization framework, where the structural context of an industry is identified as a basis for developing analyses of the performance of the industry in terms of variables such as innovativeness, prices, and financial performance. In addition, the strategic options of the firms can be analyzed in terms of their roles in this industrial structure. These analyses can be likened to the way sports announcers analyze team sports, with their commentaries on the respective team strategies during an individual game, as well as their perspective on the longer term strategies of teams in the acquisition of new players, the trading of existing players, or perhaps moving the team to a new location.

### Level Two: The Foundations of Capitalism

“Markets are ubiquitous in poor countries as well as rich,” as Mancur Olson has pointed out.<sup>7</sup> They exist in poor countries as well as rich. One of the key distinguishing features of developed countries is that their markets are underpinned by increasingly sophisticated institutions which enable them to handle more complex transactions. The need for increased sophistication at level one requires changes in level two, and this can only be achieved through appropriate action at level three.

<sup>7</sup> Mancur Olson, *Power and Prosperity*, page 173.

As we have noted above, organized economic markets are dependent upon a set of underlying institutions to give them their physical structure, rules of permissible behavior, and a way of keeping score. I emphasize the notion of organized markets because they are fundamental to capitalism. Someone can sell fruits and vegetables at an informal stand along side a road, in a rich farming area, or sell carved animals or handmade jewelry at the roadside, as is common in some developing countries. Unless these latter activities have a permit to operate they are not part of a system of organized markets. The buyer has no assurance of the provenance of the goods, probably receives no bill of sale, and usually pays in cash, indicating that the transaction is part of the informal and typically untaxed economy. Informal transactions do indeed constitute trade, but the formalization of markets was an essential step in the creation of capitalism as we will see in Chapter 4.

Prior to the advent of the railroad transport was very expensive except at waters edge, so the trading radius of a land-locked consumer would typically be very small: perhaps as much as 80% of the goods and services consumed within a year were produced within twenty miles of the point of consumption. In such circumstances the vendor's reputation was his bond; bad merchandise would hurt future sales. In addition, failure to pay was likely to end further extension of credit. However, in an economy where transport is cheap, a consumer can stop the car, make a purchase and drive on, perhaps never to return. In such circumstances unauthenticated goods can present a very substantial risk in terms of health and/or safety. Increased formalization of property rights, inspection procedures and disclosure requirements become important pillars of market operations and especially of the integration of markets over considerable distances. A credit card, perhaps with instant authentication, serves as a means of payment.

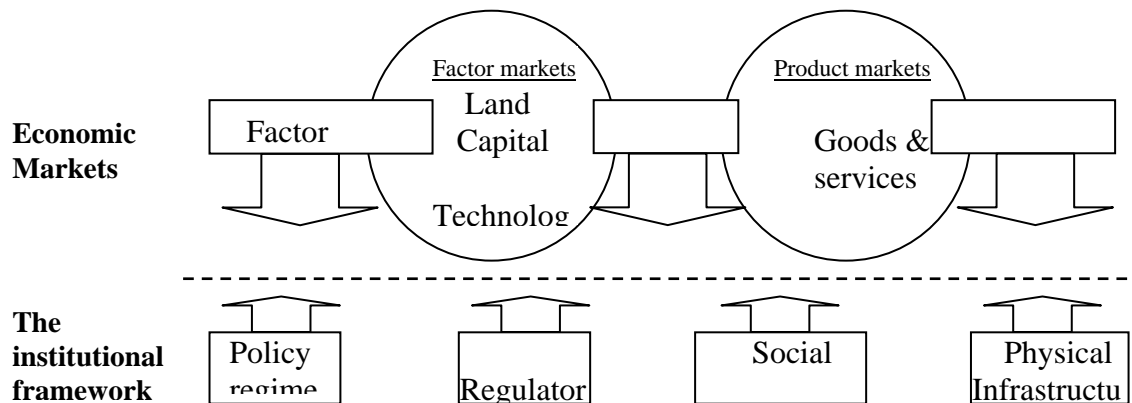
The formalization of markets depends upon the creation and legitimation of an appropriate set of institutions. While the term "institution" frequently encompasses organizations such as a central bank or a regulatory bureau, I will try to stick to a more restricted meaning of the term as laws, rules and norms that either constrain or reward the behavior of actors, whether economic or political. Thus, as implied in Figure 2.5, laws and regulations provide essential foundations for a market economy. The dashed line in Figure 2.5 denotes the dividing line between economic markets and their underlying foundations. The arrows note that the actors exercise influence in both directions.

The foundations are comprised of four elements. First, there are broad policies that have been established by the appropriate political authority in order to influence the macro economy. For example, nation-states have monetary, fiscal, social welfare, and industrial policies. Second, states also administer a number of regulatory regimes for the factor markets, such as land, labor, and capital, as well as for the product markets. For example, rules governing labor markets specify the rights of labor to organize (or not to organize), and the protection of workers from dangerous employment. The sale and usage of land is governed by zoning regulations, while credit markets are governed by rules on disclosure of information about credit terms by lenders, and equity markets have rules governing the required disclosure of financial performance of firms that are listed on public stock exchanges. Product markets have rules for competition, product safety, and environmental protection, and the taxation of sales, incomes, or both. Governments may establish

additional market frameworks for specific industries, where these are special problems of consumer safety, e.g., for regulating the production and distribution of certain drugs or dangerous chemicals.

Figure 2.5

## The Capitalist System: Levels One and Two



Source: Bruce R. Scott

Third and fourth, the state typically provides certain public goods that are commonly available, such as physical infrastructure (e.g., roads) and social infrastructure (e.g., schools, public health and welfare organizations, an air traffic control agency). It might also provide more specific types of social infrastructure in the form of academies to train police, mental health workers, or other regulators. States invest in physical and social infrastructure because the private sector typically under-invests in such goods and services; they require large investments and/or continuing expenditures, are designed for wide availability, and their very nature makes it difficult to exclude potential users and thus difficult to recover costs plus an appropriate return through decentralized markets. The state lays an indirect role in the economy in the provision of these institutions, one that is quite different from direct intervention to socialize the “commanding heights” of production, as in traditional socialism, implemented through state-owned enterprises.

In many economic analyses it is assumed that market frameworks take appropriate account of societal costs and benefits. But such frameworks are not created by an all-wise and disinterested observer; they are created, legitimated, and administered by political and regulatory authorities. If the market frameworks do give appropriate weight to various social costs and benefits it is because they have been formulated through political and administrative processes that give appropriate weight to various interests or, more broadly, give appropriate weight to the interests of the middle classes as distinct from the very rich, the very poor, or various special interests. To the extent that certain societal costs or benefits are not recognized in the appropriate market framework they are referred to as

externalities. However, this term implies incompleteness or omission. It fits with the notion of a science that is value neutral.

Given the political sponsorship of the market frameworks, we should recognize that some fraction of the market imperfections that result in externalities are not so much unavoidable technical problems as the result of deliberate distortions of these frameworks for private advantage. Such distortions are typically blamed upon governments—but let us not forget that it is private interests that often lobby and/or pressure public officials to accept and indeed champion such distortions. While small imperfections can be overlooked as acceptable aspects of an imperfect process, large, deliberate distortions for private gain are likely to add to the income inequalities in the society, creating and/or sustaining a vicious circle in which the markets serve as a way for the rich to exploit the poor. On the other hand, if a poor majority were to take political power in a country or region it could use that political power to shape institutions to disadvantage the rich, including to take their property.

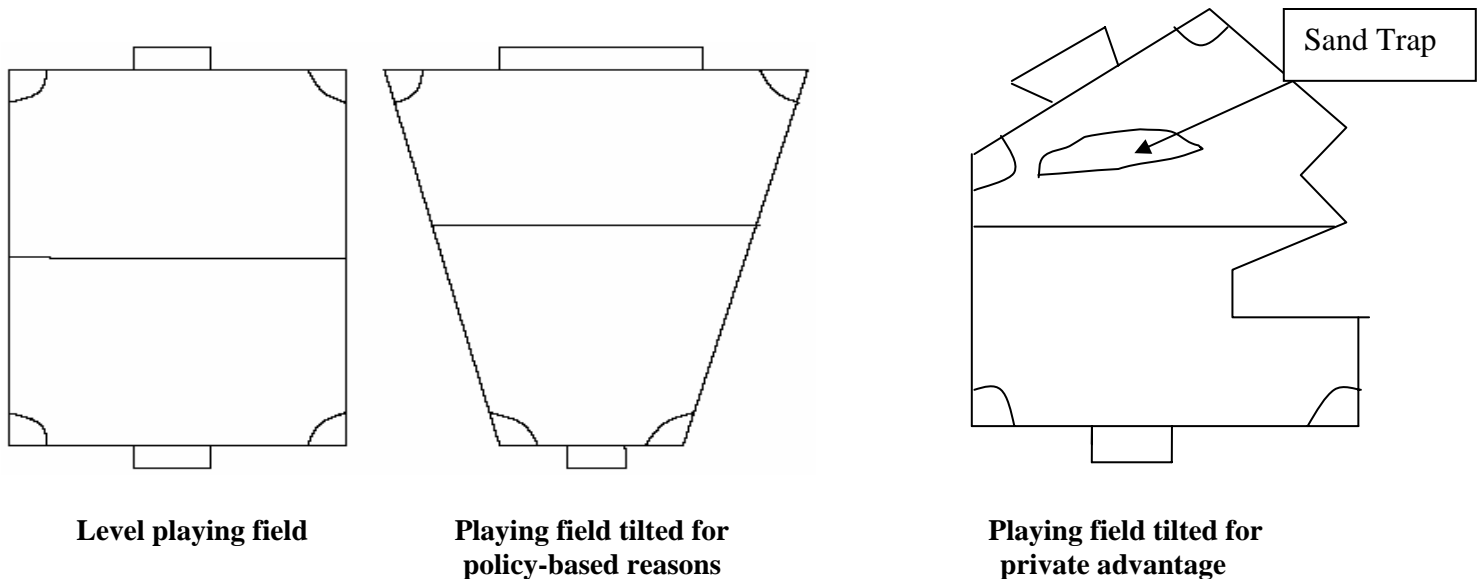
However, not all deviations from the mythical level playing field are necessarily for the benefit of special interests. Some deviations may be introduced because they give a positive “tilt” to the playing field from society’s point of view. For example, some countries, when they were relatively poor and focused on generating economic growth, prohibited the formation of unions and the practice of collective bargaining for decades, as a way to promote the profitability of firms and thus more investment and growth. Britain and the United States did so for much of the 19<sup>th</sup> century. In contrast, both the Netherlands and Ireland, which are highly unionized, used a national bargaining exercise to achieve pay pauses in the 1980s, contributing to a sharp drop in wages as a share of national income and a corresponding rise in profits. These tilts to the respective market frameworks, though very different in terms of the means employed, all helped boost corporate profits and thus the incentives to invest in the respective countries. I will return to this example later in the chapter. At this point, I simply wish to note that market frameworks can be tilted for various reasons, some public and other private, as suggested by a top-down view of a European style football field in Figure 2.6

The notion of a level playing field is a much used sporting metaphor. I want to switch the angle of observation to show that a field or market can be “tilted” in a number of ways, some of them for public policy reasons. Whereas a normal football (soccer) field is rectangular, with the centerline in the middle, it could easily be modified to favor the team at the south end by making the field—and the width of the goal—smaller at that end, and thus easier to defend. In addition the midfield line could be moved to the north side, making it easier for the south team to score on the north. Whereas any of these changes would be obvious distortions in a sporting contest, and arguably pointless because the teams could be expected to switch ends during the games, such “policy-based modifications” can be introduced and maintained in market frameworks in order to favor particular interests. For example, the south end of the field could be given to debtors versus creditors, producers versus consumers, or capital versus labor or vice versa depending upon the purpose of the intervention. On the other hand, the field could be tilted as a result of bare-knuckled lobbying behind closed doors where one interest group wins



out over others, using its economic power for private advantage. I have added a field with a “sand trap”, borrowed from a golf course, to symbolize distortions introduced to favor private as opposed to public interests. Obviously there can be mixed cases and cases in which the proponents of private gains try to masquerade as public spirited citizens.

**Figure 2.6: Alternative Playing Fields: Level and Tilted**



The cumulative nature of the gains in a capitalist system can easily tempt firms to invest considerable efforts to achieve, retain, and perhaps even enlarge their special advantages in market frameworks, even as they claim to be engaged in the constant search for the level playing field. In addition, high incentive compensation can be expected to increase the temptations for firms to use their economic power to lobby legislators and regulators for special advantages. Thus, the first two levels in the capitalist system are inseparably interrelated. And when we add level three we will see that it provides the avenue through which economic power gained through competition in level one can be used to secure regulatory advantages at level two. A tilted playing field alters the market frameworks in which decentralized decision-making takes place, whether or these changes are congruent with the public good.

### **Level Three: The Political and Social Foundations**

Ultimate responsibility for the institutional foundations of capitalist systems rests with political authorities; they have the power to decide on major policies and regulations, and the power to enforce them through the various agencies of the state. In addition, political authorities have the power to tax the many economic actors to defray the costs of government and its programs. Political authorities are typically divided into three branches: legislative, executive, and judiciary. Though the functions of these branches are broadly similar across countries, there are important differences both in relative powers and procedures. The legislative branch enacts policies, whether for spending, regulating, or

taxation, and the executive branch administers the policies and programs. However, in the Westminster system (e.g., Australia, Britain, Canada and New Zealand) the executive power rests on a majority in the House of Commons, and the respective parties control who may run for office under their banners. As a result the executive and legislative powers are much more concentrated than in the US, with its co-equal houses, often independently nominated members, and a separately elected chief executive. There are many other important differences among countries, and I will introduce some of them from time to time as we proceed.

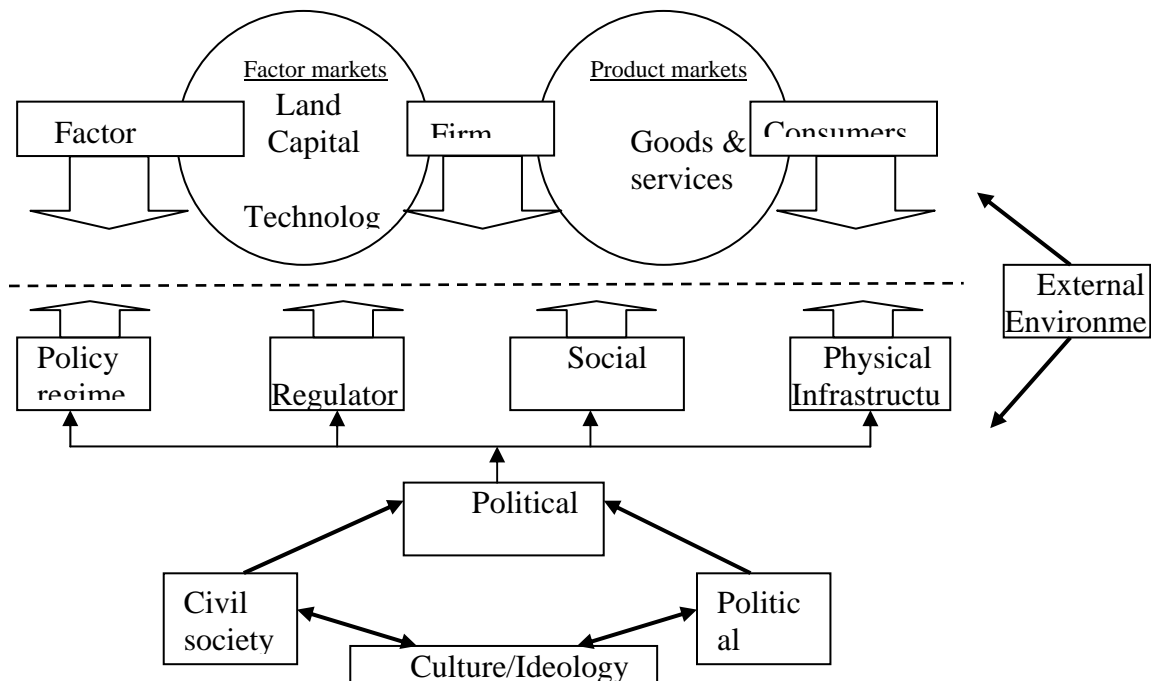
The roles and functioning of a political authority in a democratic context is more complex than might first be suggested by Figure 2.7. Whereas the arrows from the political authority on level three point upwards toward level two, indicating that the former governs the latter, in fact the diagram implies a system that is interactive. Political authority is determined by and involved in an inter-play between political markets, civil society, culture, ideology and political power. Even if we limit ourselves to liberal democracies characterized by the notion of one person-one vote, political power is never equally distributed. As explained just above, economic actors in level 1, whether factor owners, producers, or consumers can be political as well as economic actors; they can lobby the political authorities for more favorable regulations, as suggested by the downward pointing arrows in the diagram, while also contributing to political campaigns as a further source of influence. If successful, they can distort market frameworks in their own favor, either singly or as organized groups. Larger, stronger firms are apt to have more political as well as economic power.

Political markets, i.e. elections, are there to hold governments accountable to their constituents. Political markets are shaped by their own market frameworks that include the rules of protected speech, how district lines are drawn, and how candidates are selected. They also depend upon whether votes are cast directly by the voters, as in a town meeting, or indirectly, where voters elect one or more representatives for terms of office, i.e., a republican form of government. I will return to the linkages between capitalism and democracy in the next chapter, once I have formally introduced the notion of democracy and explained the complex interrelationships between economic and political power when these two systems coexist as the overall structure of governance.

The state typically provides certain public goods that are commonly available, such as physical infrastructure (e.g., roads) and social infrastructure (e.g., schools, public health and welfare organizations, an air traffic control agency). It might also provide more specific types of social infrastructure in the form of academies to train police, mental health workers, or other regulators. States invest in physical and social infrastructure because the private sector typically under-invests in such goods and services; they require large investments and/or continuing expenditures, are designed for wide availability, and their very nature makes it difficult to exclude potential users and thus difficult to recover costs plus an appropriate return through decentralized markets. The state lays an indirect role in the economy in the provision of these institutions, one that is quite different from direct intervention to socialize the “commanding heights” of production, as in traditional socialism, implemented through state-owned enterprises.

Figure 2.7

## Capitalism as a Three Level System



Source: Bruce R. Scott

In addition to the formal organs of government I have noted the presence of civil society, or the public. The public can participate in the political process in many ways, for example through political parties, non-governmental organizations and as volunteers. However, one of the key roles of civil society in the political processes of a society is to remain vigilant to see that the laws and regulations are enforced. Laws do not enforce themselves. Effective law enforcement demands the vigilance of civil society, which in turn depends on education as well as culture: the former to provide the necessary concepts and skills, the latter to provide an attitude of civic engagement and responsibility. The “demand” for effective governance is not easily built, particularly in poor countries where “vertical” or patron-client societal relationships have been the norm, and powerful people have repressed the views and the political speech of the poor. A member of civil society cannot safely express his demands for just governance unless protected by the law enforcement agencies of the state on the one hand, and the civic consciousness of other members of civil society on the other. A free press, for example, depends both on the protection of the police and the implicit promise that firms will not will not cut off advertising revenues to media that criticize governmental or business corruption.

I have listed culture, ideology and the structure of political power as other key influences upon how a democratic society works. All three are important, and I leave the exploration of their respective roles for succeeding chapters, and especially the next chapter, on how democracy and capitalism fit together. All that I want to do at this stage is to call attention to the fact that market frameworks are created through political processes and

regulated through administrative agencies, neither of which is directly controlled by the economic actors themselves. In short, the point is that economics is intimately connected to political and administrative processes. When we take economics out of this broader context we gain something in the clarity with which we can study how markets operate according to the laws of supply and demand, but we inevitably lose the perspective that market frameworks are societal constructs created and legitimated by legislatures and not by the economic actors themselves,

A century or more ago the foregoing description of how capitalism works would probably have been obvious because the relevant field of study was known as political economy. Then economics split itself off from this broader field, a process that began gradually in the 1890s and was more or less complete by 1950. There were obvious benefits that flowed from this split, but so, too, were there obvious costs.

### **Economic theory versus the political economy of capitalism**

Why the change from political economy to economics, and what were the gains and losses? One reason for the change was simply the rapid advances in knowledge and the development of more powerful analytic techniques, typically mathematical techniques. As knowledge increased there was a trend to split existing areas into more specialized areas of study, for example in the sciences. The split of economics, however, went beyond mere specialization: it was hastened and indeed driven by the creation of powerful new analytic tools and particularly by increasing utilization of formal mathematical modeling both for research and for teaching. The resulting specialization was into areas would come to have little formal connection with one another. The implications were profound.

All of us need models to help understand the world around us. Models are a way to gain clarity and analytic power through simplification. Without such simplification we flounder in confusion. Modeling has been a promising strategy in the natural sciences, as well as in economics. Paul Krugman has pointed to the plusses and minuses that are inevitably involved:

*You make a set of clearly untrue simplifications to get the system down to something you can handle; those simplifications are dictated partly by guesses about what is important, partly by the modeling techniques available. And the end result, if the model is a good one, is an improved insight into why the vastly more complex real system behaves the way it does. But there are also costs. The strategic omissions involved in building a model almost always involve throwing away some real information. ... And yet once you have a model, it is essentially impossible to avoid seeing the world in terms of that model – which means focusing on the forces and effects your model can represent and ignoring or giving short shrift to those it cannot. The result is that the very act of modeling has the effect of*

*destroying knowledge as well as creating it. A successful model enhances our vision, but it also creates blind spots, at least at first.*<sup>8</sup>

What happened to political economy? In the late 1880s economists made the pivotal discovery that goods and services were more appropriately valued in terms of what they would fetch in the market than by either how much they cost to produce or their real value in use. Why were diamonds so costly and air mostly free?<sup>9</sup> The answer was supply and demand. Air was almost free because it was in such abundant supply and so readily available. Diamonds were expensive because they were very scarce. Neither usefulness nor costs determined prices; it was a matter of relative scarcity.

This switch in terms of a theory of value or price shifted the focus of the leading academics to the determinants of supply and demand, which led to a recognition that the price mechanism would naturally and automatically establish an appropriate price among a number of buyers and sellers, as Smith had pointed out a century before. Competition would induce the various producers to adjust their output until equilibrium was reached. In this new perspective, the opportunities and costs facing the economic decision makers could be modeled with the familiar supply and demand curves, as suggested in Figure 2.3-A. These curves permitted an analysis of prospective marginal costs and marginal revenues for suppliers in the face of an estimated demand curve, and equilibrium would coincide with the point where marginal revenues equaled marginal costs. The analytic scheme was simple and teachable and yet very powerful. Initial geometric approximations would be replaced by the greater precision of algebra and then calculus.

However, the modeling of how markets operate in terms of supply and demand made some important assumptions and omitted some valuable information. For example, it assumed that there were many buyers and sellers, and no single economic actor had the market power to greatly influence prices in the markets. It also assumed that productive processes were characterized by decreasing returns to scale, and thus at some point the suppliers' cost curve turned upward as output increased. It further assumed that the market frameworks included the relevant societal costs and benefits, with little attention to how this could remain so in a world characterized by changing technologies and societal priorities. But—with all three assumptions intact—markets could be expected to reach equilibrium with the societal benefits much as Smith had recognized.

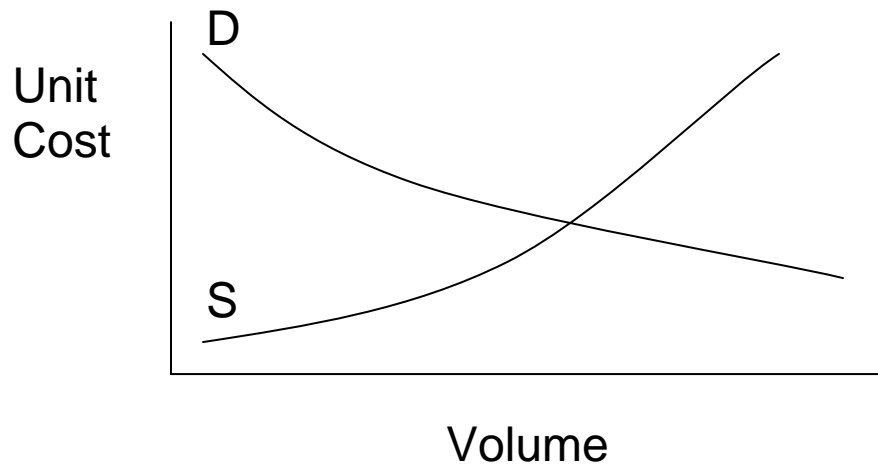
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<sup>8</sup> Paul Krugman, *Development, Geography, and Economic Theory* (Cambridge, MA: The MIT Press, 1995), pp. 71-72.

<sup>9</sup> For an excellent account of these changes see David Warsh, *Knowledge and the Wealth of Nations*. Unfortunately Warsh all but omits the informational losses involved in the mathematization of economics, and this detracts considerably from the story that he tells so clearly. (add chapter reference)

**Figure 2.8A**

A. Supply and Demand Curve with decreasing returns to scale



However, if some markets were characterized by increasing economies of scale then the supply curve would slope downward and not up, especially if the analysis was of the dynamics of a cost curve through time (Figure 2.8B). While practitioners and consultants became aware that there were many such industries, and indeed that increasing economies were a good fit for much of manufacturing, there was no way to model such a market so that it automatically reached equilibrium.<sup>10</sup> For instance, a more aggressive company could price down the learning curve to gain market share, drive others out of business, and create a dominant position. In such cases market-based solutions would yield a few dominant players or even a monopoly and not an optimal solution for society. What then?

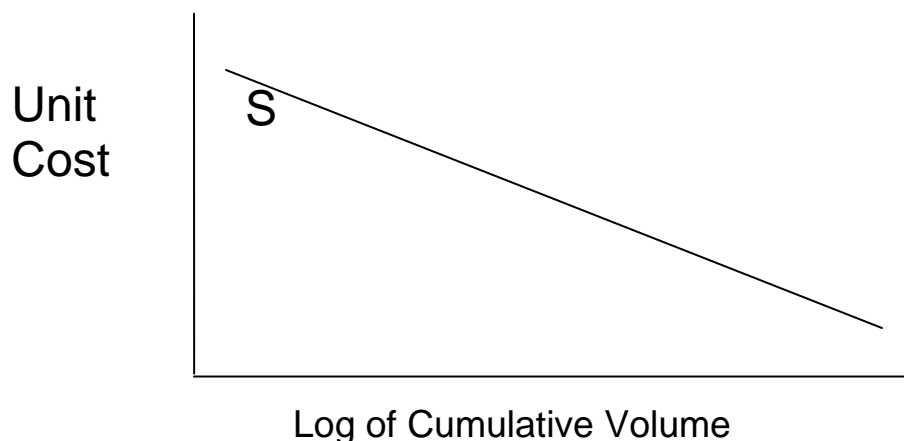
David Warsh has written a remarkable history of how microeconomic theory developed and gained increased analytic power through the use of increasingly sophisticated mathematics. He points out that for about a century economists focused almost exclusively on situations characterized by declining returns or increasing costs. For want of a model they could not “see” let alone study the possibility of increasing returns and their possible implications. At the same time he notes, very acutely, that economists have been aware of increasing returns at least since Adam Smith postulated his pin factory. Though Smith did not use the term “increasing returns,” it was clear from his analysis of the hugely increased productivity of the workers as they specialized their efforts and tools that they could increase their output more than tenfold. Smith also saw the key implication: manufactures had more to gain from the enlarging of markets than agriculture, precisely because manufactures permitted a greater degree of

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<sup>10</sup> The Boston Consulting Group played a leading role in calling attention to the cases of increasing returns and their implications

specialization and its utility depended upon the size of the market. What went largely unrecognized in this situation, was that the increasing returns in the pin factory implied that countries stood to benefit from industrialization, despite any existing advantage in agriculture. Indeed, Alexander Hamilton’s insight into the longer term advantage of diversification of the American economy to attract a wider pool of talent among immigrants as well as the possibilities for catching up in manufactures—despite its existing comparative advantages in agriculture—would inform his *Report on Manufactures* to the first US Congress.

2.8B. Supply curve with increasing returns or decreasing costs



As Warsh points out—and as my economics teachers at Swarthmore College did, as well, back in the 1950s—the attention of the profession was drawn to the case of decreasing returns because of a Malthusian predisposition to focus on the economics of scarcity.<sup>11</sup> Agriculture had been the primary source of wealth and it was also a sector of the economy that was characterized by many small suppliers and thus perfect competition. Economists focused on modeling perfect competition in a context of declining returns in part because they had just the new tools to do so. The analysis of markets with increasing returns received little scholarly attention for almost a century.<sup>12</sup> When economists such as XXX Chamberlain and Joan Robinson pointed to the need to study imperfect or monopolistic competition, their ideas were recognized but did not alter the main thrust of the field.<sup>13</sup>

In the event, the modeling of supply and demand narrowed the focus of the field of political economy to one that became known as microeconomics. Microeconomics focused on how markets operated at a point in time to yield equilibrium through circumstances that assumed many buyers and sellers and, decreasing returns. It was supplemented by a new field of industrial organization

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<sup>11</sup> Warsh, \_\_\_\_.  
<sup>12</sup> Footnote Warsh again here.  
<sup>13</sup> Warsh, with page number.

that looked not only at existing market operations but also at the potential roles of new suppliers, substitute products, alternative sources of supply, and thus the overall structure of competition. While the role of government was included as a contextual element, the focus was on the efficiencies of markets as though their frameworks included most of the relevant costs and benefits from a societal point of view. By the end of World War II, the broader notion of political economy had been supplanted by the science of economics, as symbolized by the new Nobel Prize for economic science. And, as in a natural science, the formal economic models were assumed to be universally applicable in any and all countries: the science of economics could be essentially value-free sense because it omitted consideration of the political choices involved in creating the institutional context. Douglass North has nicely summarized the implications of this shift in the paradigm or prevailing model for what had been the field of political economy into the new, much powerful field of microeconomics.

*There is simply no mystery to why the field of development has failed to develop during the five decades since World War II. Neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with how markets operate (i.e., supply and demand), not with how markets develop.... The very methods employed by neoclassical economists have dictated the subject matter and militated against such a development. The theory...that gave it mathematical precision modeled a frictionless and static world.<sup>14</sup>*

The new, neoclassical model developed in the 1890s by Alfred Marshall, a leading academic at Cambridge University, and others yielded increased precision and teach ability, but at the cost of neglecting both the market frameworks in which markets operated and the role of the visible hand of government that is so central to understanding the development and administration of those market frameworks. Furthermore, this more narrow approach made it very attractive for economists to assume that markets, as a general rule, were incorporating the appropriate societal costs. The notion that markets might be systematically biased in favor of labor or capital, producers or consumers, debtors or creditors was all too often assumed away. Furthermore it all but obliterated the idea that market frameworks might be deliberately tilted for or against capital or labor, or producers versus consumers, as matters of public policy. As economics gained in precision it became value-neutral, as if market frameworks did not embody societal choices and therefore values, e.g., for or against labor or capital. As economics became more scientific, economists all but ruled out the possibility that a society could tilt its market frameworks in accordance with a strategy that might be tailored for its own societal circumstances.

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<sup>14</sup> Douglass C. North, "Economic Performance Through Time," Lecture delivered upon receiving the Nobel Prize in Economic Sciences, 1993. Reprinted in the *American Economic Review* 84.3 (June 1994).



The modeling of supply and demand was so successful in analytic terms that its use tended to crowd out the politics and administration of how actual market frameworks were established and modified through messy legislative process, and more or less competently administered through government agencies.<sup>15</sup> Furthermore, when regulatory processes *were* studied, the familiar conclusion was typically one of “regulatory capture” by producers, a conclusion that seems difficult to reconcile with the notion that all appropriate costs and benefits had been included in appropriate measure within the market frameworks. A world-class economist like Mankiw may thus dismiss the regulatory and developmental roles of government in his *Wall Street Journal* article.

Comparative analyses of how market frameworks have evolved within a given country, or indeed across countries for a given sector, call for very different tools than the usual focus on the analysis of supply and demand within the frictionless and static context that North identifies. Comparative analysis of capitalist systems demands an interdisciplinary understanding of political science and public administration as well as economics, all in historical context. These historical and political aspects are much less readily reduced to numbers, and thus to quantitative analysis. Comparative analysis demands country specific knowledge, including knowledge of how various institutions were developed, and whether an existing bias in one or more market frameworks might be the result of private manipulation of the system for private advantage versus a shaping of those same institutions for public policy reasons, as part of a strategy for creating comparative advantages within a country. With the more inclusive framework of political economy it was possible to recognize that countries—as well as firms—could have strategies. They might be able to shape their own market frameworks to some extent in light of their own circumstances in order to induce domestic producers to build new plant capacity in areas characterized by increasing returns.

Fortunately economic historians have made remarkable progress in recent decades in exploring how institutions develop through time, and how there can be systematic differences in capitalist systems in different regions and/or countries. I will draw upon some of this work to show how capitalism arose in different ways in different geographic regions, but also to reconnect economics with political choices. This review of some of the literature in economic history unmistakably suggests that patterns of institutional development, once embarked upon, tend to

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<sup>15</sup> The narrow view also supported a rigid form of market fundamentalism wherein firms’ duty to society as well as to shareholders was to maximize profits. To do anything else was not only unfair to shareholders but a waste of societal resources. Whatever plausibility the profit (or shareholder wealth) maximizing view might have when the firm operates in a geographic area co-extensive with that of its home country’s political and regulatory authority, the argument that the market frameworks take proper account of societal costs and benefits loses credibility in a global economy. Firms are free to search for the least restrictive environments in which to produce and the lowest tax environments in which to book their earnings.

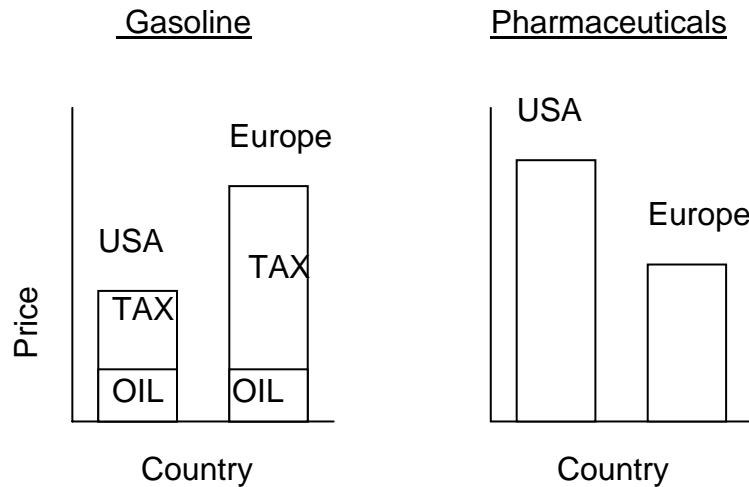
be very difficult to change. Furthermore the tenacity of institutions suggests the notion of path dependency for the capitalist systems of individual countries. This notion of path dependency suggests in turn that countries are like islands of institutional continuity in a sea of global market integration. The islands must and do adjust, but they still retain distinctive characteristics. One way to illustrate the differences between the two perspectives, i.e., political economy and economics, is to take note that market frameworks as well as underlying institutions can be quite different from one country to another. Another step is to recognize that market frameworks embody value judgments in contrast to scientifically neutral propositions. Third, I want to call attention to the ideas that market frameworks are a way to build a strategy, whether it be explicit or implicit, right into the frameworks of the market economy.

*Market frameworks differ from one country to another*

As suggested earlier, market frameworks can be quite different from one country to another, and these differences can be found in both product and factor markets. Differences in market frameworks in product markets can be illustrated by the relative prices of gasoline and pharmaceuticals between Europe and the United States in Figure 2.9. The stylized differences in gasoline prices in Figure 2.9 are accounted for largely by differences in sales taxes among various countries. Thus, the United States has a much lower tax on gasoline than its European counterparts. 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. 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 when it comes to promoting efficiency in the use of gasoline, the Europeans have taken a more market oriented approach than the United States.

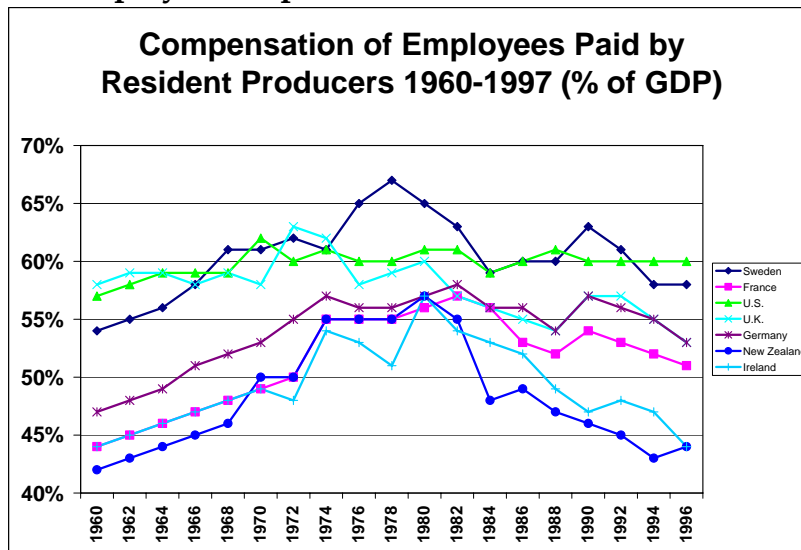
When it comes to pharmaceuticals the story is roughly the reverse. The US, virtually alone among developed countries, allows market pricing for drugs while most other developed countries have price controls. This difference in pricing policies by country has led many European pharmaceutical firms to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

**Figure 2.9. Product market frameworks differ from one country to another**



Market frameworks can also affect relative factor costs. As shown in Figure 2.10, labor’s share of national income (GDP) varies quite significantly across a sample of industrial country, with Sweden at the very top in the mid-1970s and Ireland and New Zealand falling toward the bottom as the 1990s progressed. <sup>16</sup> Labor’s share of income is almost the obverse of that accruing to capital. Sweden’s high share for labor meant that it had a low share for capital, i.e., low profitability for its firms. This made investment in Sweden relatively unattractive in the 1970s and 1980s, and when Sweden opened its capital market as a precondition for joining the European Monetary System at the end of the 1980s, it suffered capital flight and a financial crisis.

**Figure 2.10 Employee compensation as a share of GDP can be a strategic variable**



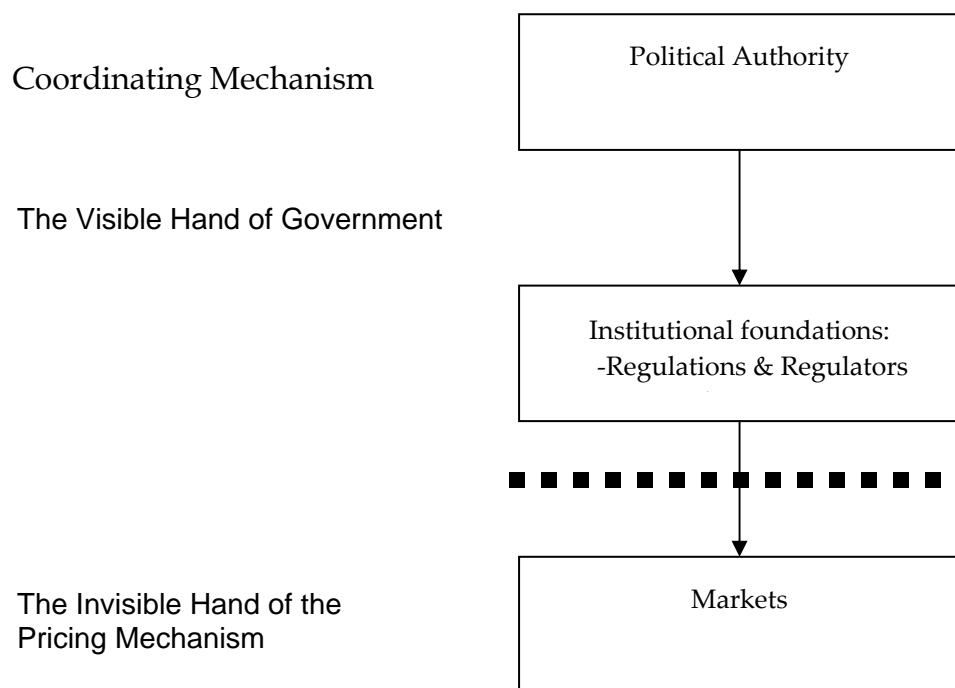
<sup>16</sup> The labor share of GDP also dropped sharply in the Netherlands, but I have not shown it for reasons of space

Ireland and New Zealand reduced their wage costs as a share of GDP by similar amounts in the 1980s, but by very different means. In 1985 Irish labor and employer representatives reached an agreement on wage moderation for a period of several years, aimed at boosting returns to capital to promote productivity growth and employment. New Zealand reduced its wages as a share of GDP for similar reasons, but through structural reforms that greatly reduced the powers of organized labor. The point of both the Irish and New Zealand strategies was not so much to reduce wages per se but to help boost profits so as to induce additional investment and job creation. In both cases government intervened to affect the market frameworks for strategic purposes, but by different approaches and obviously with differing impact on labor-management relations. I will return to this subject in the chapter on successful economic strategies.

### Implications of returning to the political economy perspective

Perhaps the most basic implication of returning to the study of political economy is to recognize that if market frameworks are to take appropriate account of societal costs and benefits, they must be so designed by political authorities; the economic actors cannot legitimately do this job any more than the players in a sport can legitimately make or change the rules as they go along. In other words, capitalism is coordinated with two hands and not one, as suggested in Figure 2.11.

**Figure 2.11** Capitalism Takes Two Hands



A second implication is that market frameworks can be adjusted to fit the circumstances of particular countries. This means that countries can have distinctive strategies tailored to their own circumstances, and these strategies may be based in part on different political prioritized, such as growth versus security or redistribution. Economic policy prescriptions that start from the premise that all markets should be liberalized to the maximum extent possible are implicitly excluding such possibilities from consideration, as the so-called Washington consensus approach has tended to do since it was introduced in the 1980s. The desire to base policy recommendations on a notion that one size fits all has tended to exclude from consideration some of the possibilities through which countries can tailor their policies to their own circumstances.

A third implication is that, even as political economy allows for the possibility of individual country strategies, globalization has made it much more difficult for any country, and especially for smaller countries, to maintain market frameworks that are tailored to their own unique circumstances. In practice this means that all market frameworks will be tilting toward capital relative to labor as time passes. Since governments are elected nationally and locally and not internationally, this will place them under increasing pressures to find ways to deal with the increasing inequalities noted in Chapter 1. Since many capitalist societies are governed by democracies, the need to find effective ways to deal with high and/or rising inequality should not be neglected.

## Summary

Capitalism is a system that is political as well as economic, or a system of political economy for short. Organized markets cannot exist without a set of institutional foundations that establish various rights and responsibilities that are attributed to various 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.

Government has two modes of intervention in an economy, direct and indirect. The indirect mode of intervention 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, one as an administrator of a going system, and the other as an innovator. The bureaucracy has most of the responsibility for the administrative role, but political leaders have the prime responsibility for promoting changes to the system. Thus, capitalism has two hands, one the familiar if invisible hand of the pricing mechanism which coordinates economic actors within the current frameworks, and the other the visible hand of government, where it is both as an administrator and as an innovator. Since market frameworks must be modernized as technologies and societal preferences, a society has little hope of progressing from barbarism to opulence unless the visible hand of the state is able to intervene to modernize market frameworks in a timely way while at the same time administer and enforce 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.