CAPITALISM AND ITS DISCONTENTS

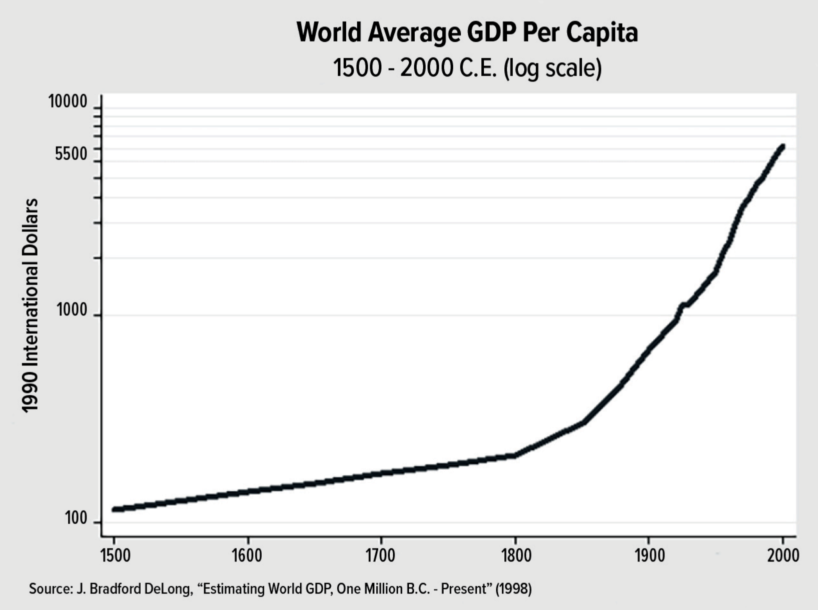
To reduce risks to their companies, boards must promote an understanding of the true nature of capitalism.

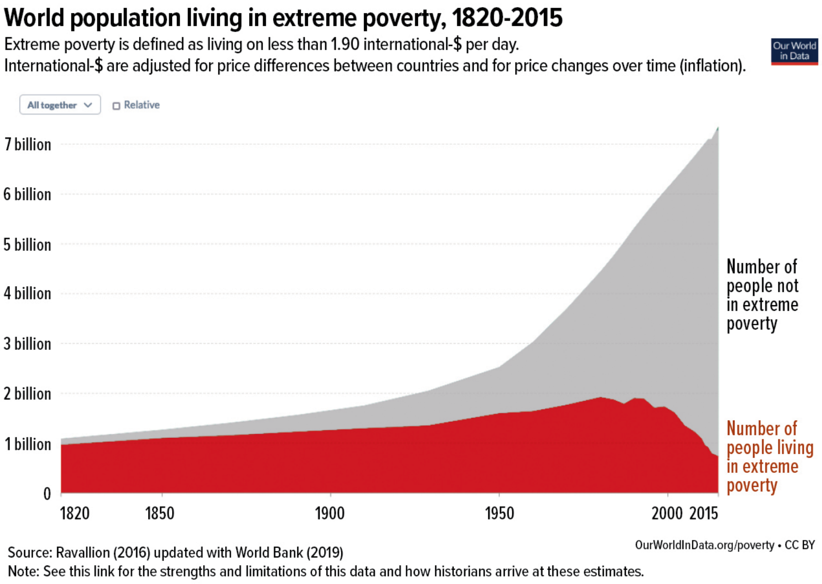
BY STEPHEN B. YOUNG

In their duty to owners, board members should act to defend capitalism against those who denigrate its advantages. This advocacy will optimize the ability of firms to create wealth for customers, employees, the community and owners. Society and humanity also will benefit, as has been the case since the dawn of the Industrial Revolution.

The promise of capitalism, according to Adam Smith, is its ability to "create the wealth of nations." And it has done so.

Consider the following charts:





CAPITALISM MISUNDERSTOOD

The function of capitalism was, I thought, succinctly put by Walt Rostow in his 1960 book *The Stages of Economic Growth*. Capitalism arrives after a national economy "takes off" and thereafter experiences self-sustaining growth.

And yet for all the wealth created by capitalism over the last 300 years, there is disappointment over and resentment of its failure to bring good things to all people. An alternative has been proposed to remedy capitalism's shortcomings: wise use of public power to provide us with happy lives. The public power alternative has taken the form of socialism in both its communist and fascist expressions and its weak version of the benevolent welfare state, with its regulation of private firms and mandatory wealth transfers from the well-off to those less fortunate.

The primary disappointments with capitalism seem to arise from:

- A categorical intellectual mistake of confusing capitalism with money, and a deeply felt objection to its reliance on self-interest and individual greed.
- Capitalism's cycles of asset booms and busts.
- The failure of capitalism to produce sufficient public goods, leading to inequality.

A discerning mind will intuit that these shortcomings of capitalism as a system of production, employment and distribution arise not from flaws inherent in the system itself but from systemic flaws in human nature. The problem is not the system; it is us, each and every one of us.

Undermining clear thinking about capitalism's achievements and shortcomings lies in rejection of our personal responsibility.

The Abrahamic religions put responsibility for life's outcomes on the individual, not on the family, the tribe, the nation or the system. Confucius and Mencius argued forcefully that we should seek to become virtuous and not live as "mean" persons. Buddha advocated personal enlightenment. The ancient Quiche Maya text, the Popul Vuh, objects to "self-magnification."

CONFLATING CAPITALISM WITH MONEY

Many wrongly confuse capitalism with money.

The Apostle Paul was convinced that the love of money is the root of all evil. Money is a pre-capitalism human invention. Traditional societies used money. Socialist, even communist, economies use money. As a consequence, those economies could not escape from the selfish abuse of money power.

THE "NECESSARY EVILS" OF CAPITALISM: PROS, CONS AND SOLUTIONS

Proponents of the following nine practices argue that they are good and necessary. Their arguments are usually in response to a proposed bill, rule, regulation or stockholder proposal advocating for a ban or curb on them as if they were evil. In each case, ways of working with these "necessary evils" can emerge from their pros and cons.

ALGORITHMIC TRADING

Pros. Uses computer power to improve buy-sell decisions and speed their occurrence based on if-then formulas.
Cons. Entirely dependent on quality of programming. Can intensify buy or sell panics.
Solution. Continually improve programs and use market circuit breaker if market overheats.

BUYBACKS

Pros. Enables companies to increase the shares they hold, decreasing dilution of share value and lowering chances of involuntary change of control. Also increases flexibility of executive and employee compensation programs.
Cons. Deprives company of cash that may be needed for capital investments, R&D or dividends.
Solution. Set policy for capital allocation to ensure appropriateness of buybacks.

CEO PAY INFLATION

Pros. Basing CEO pay on stock price (one major cause of pay inflation) aligns CEO decisions with shareholder interests and, if structured for generous outcomes, can give boards a wider choice of leaders, as some are reluctant to jump ship without a major financial incentive. High pay puts greater pressure on the CEO for high performance.
Cons. CEO pay that is high relative to peers and other employees can be a magnet for stakeholder criticism and can incentivize short-termism. Seeing the CEO as an "owner" is contrary to the CEO's fiduciary duty as an officer.
Solutions. Restructure pay packages to be heavier on base pay and lighter on equity pay, structuring the latter solely as restricted stock grants. Eliminate stock options entirely except for start-ups. Ensure that golden parachutes, if any, fall below the "excessive parachutes" level that triggers taxation.

DERIVATIVE HEDGING

Pros. Enables companies to offset their strategies without making major and possibly irreversible capital investments.
Cons. Can lead to disastrous outcome if bets are wrong and big.
Solution. Ensure expertise of choice and use in moderation.

GOLDEN PARACHUTES

Pros. Being assured of continued pay after a change of control will prevent CEOs and senior executives from resisting an acquisition offer that may be in the best interests of shareholders and other stakeholders.
Cons. Golden parachutes, if overly generous or too easily triggered, can create a perverse incentive to sell the company and depart from leadership when this is not in the long-term interests of shareholders and other stakeholders.
Solutions. Ensure that golden parachutes are triggered only when two events occur — change of control and dismissal/demotion (so-called double-trigger). Also, make sure that they are reasonable in size (e.g., will not trigger Rule 280G taxation as "excess parachute payments").

LOBBYING

Pros. Gives companies the chance to tell their story in detail directly to legislators and regulators, supplementing and balancing media accounts that can be overly simplistic or unnecessarily negative.
Cons. When combined with political contributions — especially through anonymous PACs — can have undue influence on legislative and policy decisions.
Solutions. Require transparency in both political contributions and lobbying. Via an ethics code, set boundaries on lobbying so it does not cross a line into rent-seeking and anticompetitive behavior.

POLITICAL ACTION COMMITTEES

Pros. Can be a way for corporations to support candidates and policies consistent with the needs of their industry, contributing to better state and national policy.
Cons. Can cause corruption and confusion — the identity of contributors to PACs may be known to candidates, who may be beholden to them, but not to voters, who may be misled by them.
Solutions. Get buy-in on PACs from stakeholders. Candidates and companies should be transparent, disclosing sources of funding and purpose of formation. As stated above (under "Lobbying"), ensure ethical behavior to avoid rent-seeking and anticompetitive behavior.

RESTRUCTURING

Pros. Enables companies to weather hard times through structural changes, such as layoffs that lower labor costs, divestitures that raise cash or share buybacks that discourage takeovers.
Cons. Can cause loss of talent, business lines or funds that will be needed later.
Solution. Consider impacts on all stakeholders in the short and long term.

SHORT SELLING

Pros. Can prevent overvaluation of stock by betting on a reasonably likely downturn.
Cons. Can drive stock prices down too low based on false information.
Solutions. Refrain from short selling. Support stocks victimized by short selling. At the exchange level, insist on strong circuit breakers per Regulation SHO (but with no exemptions).

When Charles Dickens created his wealth-accumulating character Ebenezer Scrooge, he made him a moneylender who heartlessly collected debts owed to his firm. In his magnum opus *Das Kapital*, Karl Marx stigmatized a capitalist as "Mr. Moneybags": "His person, or rather his pocket, is the point from which the money starts and to which it returns."

When love of money takes over our souls, we scheme for ways to extract "rents" (cash money) from others without allowing them much, if any, bargaining leverage. Such transactions are pretty much "take it or leave it" and lack fairness. Economists call this behavior "rent seeking" and "rent extraction." The latter happens when we have power — political power, social power and market power (monopolies, oligarchies, protective regulations, patents and copyrights). This kind of capitalism is more correctly understood as "crony capitalism," or a system of collusion between rent-seeking officials and private enterprises at the local or national level.

The love of money, as Saint Paul warned, stokes desire in our hearts and encourages our minds to scheme. The more money, the more we can be tempted.

Money gives us power when, as Lord Acton warned, "Power corrupts and absolute power corrupts absolutely."

Now, power is necessary for human flourishing. We can have no individual agency without power. Assets — intellect, skills, charm and wealth — drive life outcomes. The wealthy, no doubt since the dawn of time, have lived better than the poor in every culture.

Thus, we must accept owning money as a human good, even as a human right, perhaps. But the circulation of money can distort our judgment and warp our values.

Since capitalism produces more wealth than any other economic system, it generates money, which is both a public benefit and a private good. But money power is also a source of inequality and unfairness, as owners, workers, consumers and governments all bend their wills day in and day out to get money.

But capitalism is far more important to humanity than money. Capitalism raises living standards and thus brings hope to societies and individuals.

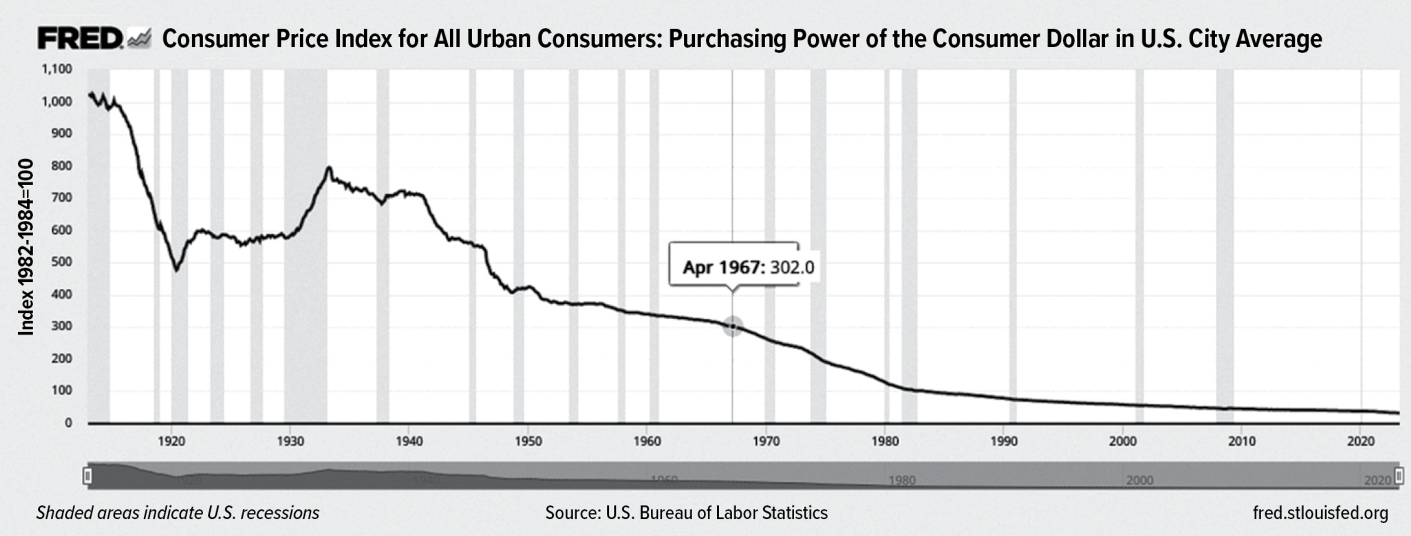
Briefly stated, one of the most ingenious capacities of capitalism is its superior ability to restrain excessive abuse of money power. Through competition, a prolific mechanism of checks and balances, capitalism uses self-interest to constrain self-interest. Inequality of outcomes in market economies very often comes about when competition is replaced with modes of rent extraction.

BOOMS THAT END UP IN BUSTS

In addition to wrongly objecting to capitalism because it thrives on the circulation of money, there is anger that, from time to time, capitalism does not create wealth but destroys it, or rather destroys the monetary value of assets.

People buy assets with money. They invest to make a profit and so enhance their agency capacity. But sometimes assets lose market value over time as buyers don't value them as highly as they once did. Owners then become poorer in money.

Financial crises have happened since the dawn of capitalism, including the Tulip Mania in Holland, the South Sea Bubble in England, the Mississippi Bubble in France or, closer to home in the United States, the 1929 stock market crash, the 2008 collapse of credit markets and the recent collapses of some regional banks.



Taking on debt can also lead to financial distress. The borrower can misjudge the probability of repayment or events can happen that deplete the borrower's stock of ready money available to repay the debt. Too much debt is just as much a risk of potential loss as is any net present overvaluation of assets.

The cause of these losses is not the system of markets but lies in the minds of buyers and sellers, borrowers being only buyers of money. Human nature disposes us to making misjudgments and so choosing illusions over reality. The old saying was "If wishes were horses, beggars would ride."

Both financial crises and debt/income mismatches arise from misjudgments in valuation. In financial crises, the market value of financial contracts becomes unrealistic or even irrational, and then buyers balk, driving prices down. In assuming debt, the value of the asset, or the net present value of future earnings, is misjudged. In time, the borrower lacks capacity to repay the financial obligation and must default, most likely losing ownership rights to the asset.

Now in its own way, capitalism provides a check on making excessive valuations. At some point in a competitive market, prices get so high that the supply of buyers shrinks and prices must drop to draw them forth again. The rationality of self-interest — human nature — prevails again. But here state action intervenes to affect the price equilibrium in financial markets. Financial enterprises are regulated, and the state influences the value of money by increasing or decreasing its supply.

The chart above depicts the real value of the U.S. dollar over the years the American welfare state was evolving into its present scale as the federal government injected more and more money into the economy.

But it is not feasible for capitalism as a system to correct misjudgments of individuals about their ability to assume and repay debt. In some jurisdictions, however, bankruptcy laws attempt to minimize the harm done to borrowers by such misjudgments.

NOT ENOUGH PUBLIC GOODS

There is disappointment that capitalism does not produce, either in quality or in quantity, the public goods many desire and that capitalism does not sufficiently inhibit the production of public "bads." In economics, this is the problem of externalities — the consequences that come with our actions.

Consider our need to offset the accumulation in our planet's atmosphere of trillions of tons of carbon dioxide, leading to changes in our weather and climates. Capitalism gave us the Industrial Revolution. The Industrial Revolution has given us climate change — a public "bad" — as an unintentional by-product of its technologies.

Public "goods" are things like education, housing, a living wage, healthy food, roads and bridges, and freedom of speech and thought. Capitalism does not internally generate these goods in quantity. Nor can capitalism always provide them in quality. Capitalism is a pay-as-you go system when most of us either can't, or are unwilling to, pay for these and other public goods.

This third source of dissatisfaction with capitalism also arises from the quandaries of human nature. How far does my duty to others go? How much should I sacrifice my money to benefit others? Am I always my "brother's keeper"? Doesn't "my brother" have obligations arising from human dignity to make the best out of life? Am I a steward of community well-being, or is that the government's job?

A notorious insight of Adam Smith gives us a clue about capitalism's capacity to bridge the gap between our private interest and the creation of public goods. Smith observed that we humans live by "truck and barter." What I don't have, maybe I can get from you — that is, if we can agree on an exchange value between what I want and what you have. Smith pointed out that, often, self-interest more than altruism generates outcomes that benefit others. In that sense, something of a public advantage is created by the intersection of differing self-interests. Both parties to the exchange benefit and society is better off for their having benefited from one another.

Consider education and health care: Are they public or private goods?

On one hand, both education and health are private goods. The individual "owns" the advantage that comes with education and good health. They contribute importantly to personal human capital balance sheets.

On the other hand, a society that has provided high levels of human capital for its members is more productive, more resilient, more progressive, more tolerant — all important public goods. Such goods are "non-rivalrous" in the language of economists, and so are shared in common with all members of the community.

I call these goods "quasi-public/quasi-private," as they are an amalgam of that which belongs to one and that which also benefits others.

Decelerating climate change follows a similar model. Some innovative private goods or services — electric vehicles; new, smart, nuclear reactors; carbon removal and sequestration; changes in production methodologies for cement making and shifts in agricultural practices — have public benefits.

So, one way capitalism can achieve more in the production of beneficial "public" outcomes is to introduce products and services that will attract customers willing to buy such quasi-public/quasi-private goods.

The appropriate competence of the state in encouraging such production of quasi-public/quasi-private goods is to transfer "rents" from taxpayers to private entrepreneurs to shift the risk/return calculus associated with their private interests toward more favorable valuations of their innovative enterprises.

The state can also adopt and enforce laws that change the calculus of self-interest on the part of market participants. Law can set specifications, provide preferences and impose penalties on goods and services. The state can thus constructively change the calculus of self-interest — bring the cost of future consequences into the present to minimize the deleterious and shortsighted effects of unenlightened self-interest.

Thus, capitalism with help from the state can cope with human nature, warts and all, to better serve the common good. Though many of capitalism's perceived evils stem in fact from our human nature, capitalism can influence our behaviors for the better but will never change our natures.

IMPLICATIONS FOR BOARDS

Boards of public companies would be wise to promote this understanding of capitalism in order to strengthen the performance of the companies they serve and to advance the common good. Capitalism is a quasi-private/quasi-public system dependent on our human nature but capable of offsetting our shortcomings.

Understanding the true nature of capitalism — including what appears to be its list of necessary evils (see the sidebar on page 17) — will enable directors to respond to the many issues confronting them in the course of fulfilling their duties. At the same time, board members must act with a view to optimizing the public goods produced by the companies they supervise and minimizing the public "bads" associated with the goods and services that those firms introduce into our economies. This goal is consistent with their duty of due care to owners. Optimizing the benefits and minimizing the harms will lower risks and increase the firm's net present value as enlightened self-interest always seeks to do. ■

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