WHY CAPITALISM?

OPPONENTS OF CAPITALISM and free markets frequently claim that one or another of the periodic crises that occur foreshadow the end of capitalism. Most recently, such predictions followed the recent financial crisis. The 2008 housing-credit crisis was a serious, but temporary, decline—not a permanent loss of wealth, much less "the end of capitalism," as some proclaimed at the time. Capitalist systems have weathered many more serious problems and all survived this one.

Today, capitalism is the economic system that guides most of the world—having overcome unremitting intellectual hostility, as well as military hostility from Communist nations during the Cold War. Yet even China and formerly socialist India have embraced market economies. Both recently pledged to maintain them, along with South Korea and Australia.

Capitalist systems are not rigid, nor are they all the same. Capitalism is unique in permitting change and adaptation, so different societies tend to develop different rules and processes, often reflecting cultural requirements. What all share is ownership of the means of production by individuals who remain relatively free to choose their activities, where they work, what they buy and sell, and at what prices. As an institution for producing goods and services, capitalism's success rests on a foundation of a rule of law, which protects individual rights to property, and, in the first instance, aligns rewards to values produced. Working hand in hand with the rule of law, capitalism gives its participants incentives to act as society desires, typically rewarding hard work, intelligence, persistence, and innovation. If too many laws work against this, capitalism may suffer disruptions. Capitalism embraces competition. Competition rewards those who build value, and offers buyers choices and competitive prices. Like any system, capitalism has successes and failures—but it is the only system known to humanity that increases both growth and freedom.

Critics of capitalism often complain that the distribution of income generated by the market system is unequal. They point to capitalism's frequent periods of unemployment and instability, and its rewards for selfish rather than for socially beneficial, cooperative activity. Some favor heavy regulation to achieve social goals. Others favor putting a public institution, or the state, in control of allocating resources. Talk of equity and fairness generally means wealth redistribution. But no economic system focused on property confiscation and redistribution has ever sustained both growth and personal freedom.

Critics of capitalism usually ignore or discount incentives, which are part of the engine that drives progress. Income differences reflect differences in individual ability and the value that markets place on particular activities at particular times. The relation of reward to effort or achievement may not be precise, but it is positive.

Many defenders of capitalism present it as a moral system—that it is morally right for people to use their own resources as they choose. The problem with the moral defense of capitalism is that it ignores or discounts the occurrence of venal or illegal activity and expedient, self-serving decisions.

All people are not honest all of the time. Greed leads people astray. Generally accepted moral principles also don't make specific decisions any easier for a society to agree upon. People who share common moral principles often disagree about their precise application—the death penalty and abortion are among many ever-present examples.

It is of course true that any system works best if the participants share moral principles such as honesty and commitment. Moral principles are important in any economic system. Yet these are not part of the system; they are attributes of individuals. Capitalism and its incentives may be a more potent force encouraging honest dealing, if only because competition induces honest behavior more often than other systems. But capitalism works in corrupt environments as well.

The rule of law is the principal, partial substitute for a moral code. To function efficiently, or to function at all, a capitalist system requires rules, many of which impose moral principles. The law must protect individuals and property, enforce contracts, sustain faith in the stability of the system over time, reduce uncertainty, and respond to political and social pressures.

Long ago, the great German philosopher Immanuel Kant told us why the moral defense of capitalism couldn't be relied upon. In 1784, he wrote that "out of timber so crooked as that from which man is made, nothing entirely straight can be carved." Everyone is not honest, a point reinforced by periodic scandals. Kant's statement restates medieval Christian orthodoxy. Humans are morally imperfect, and so are their institutions.

Private and public officials often break the law. Kant's dictum applies at least as much to public as to private officials, and criminality cannot be reduced by choosing socialism or the welfare state. More likely, it is increased: Siemens was convicted of bribing officials in many countries; Enron, WorldCom, and Madoff are recent examples of unethical and illegal corporate behavior; Watergate and the Russian takeover of oil companies are examples of public malfeasance; bribery and corruption of officials are recurring problems in China. There are simply too many examples to cite. Capitalism and markets disperse power; centralization and collective action concentrates power and increases the cost that the public bears.

Capitalism survives and spreads because it recognizes Kant's principle. People differ: some give bibles, but some sell pornography. Unlike its alternatives, capitalism does not take a utopian view of economic organization or replace man's choices with a legal command that someone's idea of perfection be implemented. It permits a choice for change, then allows change to be rejected after one sees the outcome. It recognizes that all change is not necessarily an improvement and will not necessarily be welcomed by all, and it accommodates those differences by letting individuals choose for themselves. Over time, people observe others' successes and follow suit. Capitalism therefore has a means of removing failures. Competition eliminates less efficient activities and strengthens survivors by encouraging them to adapt to change.

Socialism and other utopian systems are more rigid. They represent someone's belief in the aims of a stated ideal that certain "good people" embrace—if movies are too violent, then they must change; if television is too banal, it must be improved. But such change is always an imposed choice by some individual and on lines subject to uncertain or disputable interpretations. Freedom lets people make their own choices, even if they violate someone else's idea of proper norms or right conduct. Socialism seeks to restrict choices only to those that officials will permit. Capitalism accepts that in a market economy some people's choices won't please everyone, for individual tastes and desires differ. Like Kant, capitalism does not seek utopia but lets markets accommodate differences, leaving most decisions to individuals, who then can learn from the outcomes of their own choices and by observing the outcomes of their neighbors' choices.

Freedom of choice brings more satisfaction to more people—even in nonmarket situations. Nothing assures that taken together everyone's choices will meet any particular ideal of the good, the wholesome, or the moral—yet choice in a capitalist system will nevertheless, at the individual level, satisfy many by continuing to satisfy their changing demands. Further, the choices individuals make inform others, thus enabling the market to respond to demand.

Competition brings choice and improved relevance not only to commerce but also to religion. James Madison believed that competing churches would prove stronger than an established state church—because each would appeal to its members and try to attract others. Time proved Madison right. In Europe, the state supports established churches, yet organized religion is weak; the public rejects the state's religion monopoly by simply not participating. Human intelligence is found everywhere, yet the United States has the world's strongest, most progressive universities because its universities compete for the best and brightest of scholars and students, and for money; our competitive impulse drives change, ideas, and innovation. Because U.S. universities attract quality students and researchers from all over the world, they remain vibrant and exciting places operating at the frontier of knowledge.

Capitalism does not solve all problems efficiently. Long ago, John Locke recognized that some services call for collective action. For instance, society was clearly better off if everyone paid taxes to support a public service such as police or night watchmen. Locke ruled out a complete system of market allocation without any public intervention but created the rationale for collective action in place of individual choice for some types of activity, called public goods.

Once we accept that collective action is the preferred method of allocating some resources, we introduce a government with the power to tax, and the system becomes a mixed capitalist system.

Revealingly, the recent outcry over the financial crisis blamed unregulated markets and deregulation as a cause of the financial crisis. Without doubt bankers made mistakes that proved costly to everyone. Inept regulation is more to blame. All financial markets have been heavily regulated for decades. After 1999—when investment banks and commercial banks were permitted to merge with the removal of the 1933 prohibition imposed by the Glass-Steagall Act—very little deregulation occurred. No other country adopted similar regulations. No one has yet explained how ending the separation between these businesses, formerly required by Glass-Steagall, contributed to the crisis. The Basel Agreement required banks to hold more reserves if they increased risk. Regulation thus addressed the problem but was overlooked or disregarded. The banks responded to Basel regulation with evasion by putting their risky assets in off-balance sheet entities. So in effect, Basel increased risk by inspiring evasion that was nontransparent. Simultaneously, investors were overassured that regulatory oversight existed and could be confidently relied upon, when it could not be. This followed my first law of regulation. Lawyers and bureaucrats regulate. Markets circumvent regulation. My second law of regulations says: Regulations are static. Markets are dynamic. If circumvention does not occur at first, it will occur later. Regulation then often misleads the innocent.

Effective regulation rewards intelligent transactions and punishes bad ones. Regulation may create a monopoly, raise barriers to entry, or incentivize socially desirable behavior. For example, to limit banks' size and appetite for risk, regulation might require that capital increase faster than assets. Increasing firm size increases costs that managers and stockholders, not the public, should pay for.

In any mixed system, the distribution of responsibility and authority between public and private sectors has to be governed by rules. Most capitalist countries run public goods such as national defense and the police democratically, with voters choosing how much to be taxed versus the size of government. Voters decide matters at a high level of abstraction, leaving government to set precise rules for market behavior. Democracy means that majorities can shift responsibility from the individual to a collective—that is, to the creation of a welfare state.

DEMOCRATIC CAPITALISM

Voters can also act to collectively provide public goods other than defense and police protection by, for example, blurring the lines between private and public authorities and responsibilities, increasing or reducing the government's role in redistributing income, and regulating private sector activities. Elections often are about choosing between the party that favors economic growth through lower tax rates and less government regulation versus the party that wants more government programs to redistribute income and expand government's role and size, thereby supplanting private goods or extending activities in place already, such as education, health care, or nursery schools. Government programs can provide services at below market prices by shifting the cost of their operations to other taxpayers, current and future. A desire to expand access to such services does not necessarily mean that they must be supplied by the government.

Democratic capitalism allows voters sometimes to favor higher growth and at other times to favor redistribution. Critics of capitalism who emphasize "fairness" often do not recognize that this word is hard to define, for the system is not static, but ever-changing, with the "fair" result changing with it. The word "fairness" is often a way of avoiding mention of the real goal of such critics, redistribution. Proponents of fairness generally want more private goods to be supplied publicly at subsidized prices or increased spending on welfare—to be paid for by taxes on those with above median income or by the issuance of debt to be paid by later generations. Much legislation or regulation presented as "fair" leaves large debts to future generations.

Democratic capitalism tends to deal with the Kantian problem by cracking down on excesses by owners or managers of capital assets with regulations that seek to deter socially undesirable behaviors or to tax behaviors or outcomes that majorities dislike. Recent attacks on smoking show how changes in public attitudes drive legislation. Because outlawing alcohol and narcotics were famously unsuccessful in the past, today's anti-smoking crusades seem to be restricted to raising taxes on tobacco sales rather than a ban.

Regulation to achieve social objectives has two major problems. The first law of regulation says that lawyers and bureaucrats develop regulations, but markets learn how to circumvent those that cost them money. The second says that the results of regulation often differ from the regulation's goal or plan.

Circumvention occurs in many regulated markets. The Basel agreement meant to regulate but wound up increasing risk. Similarly, the goal of campaign finance reform to rid politics of the noxious influence of money and to cap presidential candidate spending to a sum regulators would decide at first appeared laudable. But it failed: the 2008 presidential election turned out to be more costly than ever, with only one of the major party candidates accepting taxpayer funds and a limit on spending. The legislation limited spending by candidates and parties but not by interest groups. The result was to further weaken political parties, which work to harmonize divergent interests, and increase the influence of single-issue groups, which often work to magnify differences and so make policy compromise more difficult. This was not the outcome proponents of McCain-Feingold or similar campaign spending legislation had promised or anticipated. Quite the opposite.

Regulation is socially useful if it aligns private and social costs, as when people pool funds for the "night watchman"; collective action might be more efficient (less costly) than private. But not all regulations meet that test. If I were to articulate a third law of regulation, it would be that the aim of regulation in a market economy should be to equate private and social costs because whenever it doesn't, the regulation simply invites circumvention. Then, although the regulation gives the appearance of protection, the world may in fact have only been made riskier by lowering individuals' guard against caveat emptor. Many inefficient regulations stay in place indefinitely because they benefit a special interest group who then makes it their business to sustain them. Agricultural subsidies for high-income farmers, for instance, are programs that persist and even grow. Peltzman (2004) offers another reason: the "capture" of regulatory agencies by the regulated, a phenomenon now supported by a large economic literature. Under democratic capitalism, costly distortions of this kind seem unavoidable.

Many critics of deregulation cite the Gramm, Leach, Bliley Act, which repealed the separation of commercial and investment banking established under the Glass-Steagall Act of 1933. Such critics usually don't specify what problems this repeal caused or recognize that Glass-Steagall had been circumvented long before its repeal. Investment banks and commercial banks engaged in similar activities. The main remaining difference was that commercial banks held demand deposits. Like investment banks, they financed many of their activities in the overnight market. Costly regulation encourages circumvention. Compliance with regulation is bought from legislators by granting the regulated industry a monopoly or by enacting strong penalties against circumvention. This suggests that more research on the political economy of regulation, its persistence, and its evasion—and what types of regulation are most efficient in what circumstances—is needed.

Democratic capitalism alternates between more and less intrusive government, based on overall voter preference for more or less redistribution, or higher or slower growth, usually based on just past results. Periods of low growth make voters favor reducing taxes and regulation. Periods of sustained growth often spread the distribution of income, causing voters to prefer larger transfers and higher current or future tax rates (Meltzer and Richard, 1981).

Raising tax rates or regulation shifts control of resource allocation from private to public managers. This does not avoid the Kantian problem; the form may change, but humanity's problems remain, as neither the public nor the private sector contains only virtuous people. The many examples of corruption, bribery, and misfeasance cited above are a just a small sample. Offenses such as bribery can be either public or private and are common in many nations, but they are most common where government officials have the most authority.

Reduction of air pollution is a public good. Everyone can pollute by adding noxious gasses to the air. Economists would have users pay by taxing carbon. Higher gasoline taxes stimulate production of less harmful substitutes and the search for alternatives. Many voters do not want to pay an additional tax, so politicians are unwilling to vote for such taxes. The alternative is regulation, which is less efficient, but the costs paid are less observable and their burden can seem to be imposed on producers, who then are blamed for shifting the cost to consumers.

Public sector regulators are inclined to be more cautious and more anxious to avoid failure than entrepreneurial capitalists. Decades ago Sam Peltzman showed that the Federal Drug Administration placed too much weight on avoiding drugs and medications with potentially harmful side effects that were relatively minor because they failed to account for the losses from restricting the benefits of such drugs, a bias that has never been corrected. This outcome is very different from the choices people would make in the marketplace. And, like all regulation, rule making and rule enforcement can be pressured or controlled by special interest groups.

Regulatory "capture" by interest groups occurs often. The Federal Reserve often acts as guardian of the New York banks' interests. The Federal Aviation Administration discourages and even punishes employees who call for strict enforcement of safety rules. There are many other examples of misdirected government regulation.

Well-run companies plan for the long term. But governments typically follow the political cycle, a much shorter term. Private sector companies make investments that increase employment, productivity, and output. Public spending responds to public pressures for redistribution. For example, AIDS research receives substantial funding because its advocates are active; other diseases such as Alzheimer's for which organized advocacy is lacking receive less. Although much spending is defended or promoted as a way to help the neediest, large spending programs transfer mostly to the middle class, as that is where most of the voters are.

Democracy is another way to allocate resources. Generally, those who succeed in the marketplace favor allocation by markets, not governments. Those who do not succeed favor government redistribution, joined by those who dislike capitalism or prefer collectively mandated "social justice" over market efficiency. Actual social outcomes are a compromise between the two aims.

Congress very often approves legislation but leaves detailed regulation to the regulators. This substitutes the rule of regulations for the rule of law, thereby reducing the extent to which we have a government of laws, not a government of men (or women). Reducing the scope of the rule of law damages capitalism. Examples abound. Sarbanes-Oxley legislation reduced the attractiveness of U.S. equity markets. Many foreign firms left. Much regulation has the effect of replacing the rule of law with arbitrary decisions by lawyers and bureaucrats.

ALTERNATIVES TO CAPITALISM

The critics of capitalism always decry "greed" and "self-interest" and invoke "social justice" and "fairness." Socialism, Communism, or authoritarianism are generally proposed as an alternative, yet these systems have persisted mainly under police states. This is not accidental. Orthodoxy must be enforced on the unwilling. The main alternative is the regulated welfare state, which is discussed in the next chapter.

Anti-capitalists err in three ways: first, by ignoring Kant's warning about human imperfection; second, by ignoring individual differences while substituting in the name of proclaimed goals such as equality, fairness, or justice rigid direction in place of individual choice. Justice and fairness are imprecise terms subject to individual interpretations with no fixed standard. Their third error comes in practice: the choices of the ruler often have to be enforced using fear, terror, prison, or punishment. The 20th century is rife with promised ends that were never realized that turned into a justification for deplorable means.

Assigning decision-making authority over resource allocation does not eliminate crime, greed, self-dealing, conflict of interest, or corruption. Experience tells us these problems remain, regardless of the system's form. Ludwig von Mises recognized in the 1920s that top-down price fixing and resource allocation eliminated important information from the system. Capitalism allocates by letting relative prices adjust around the trade-offs expressed by buyers' individually expressed needs, which constitute their overall demand. Replacing consumer choices with an official decision fails to incorporate these accurate, individual, cumulative buy-sell data into the system, thus distorting prices. At the set price, some will gain, but others will lose. By contrast, a freer system allows market equilibrium prices to evolve based on the actual, accurate demands of all. Those who lose in the ordered system would have preferred to choose for themselves.

Not all socialist societies have turned brutal. In the 19th century, followers of Robert Owen, the Amana people, and many others chose a socialist system. Israeli pioneers chose a collectivist system, the kibbutz. Still, none of these arrangements produced sustainable growth, and none survived. All faced the problem of imposing allocative decisions that satisfied the decision-making group and sometimes reflected a majority view but often did not. Capitalism recognizes that where individual wants differ, the market should be free to respond, so that minorities can develop their own best outcome. Walk down the aisles of a modern supermarket. There are products that satisfy many different tastes or beliefs. Diversity of this degree does not occur in nonmarket economies.

Theodor Adorno was a leading critic of postwar capitalism who found popular culture vulgar, as it developed in his native Germany and the West. He distrusted workers' choices and called for a socialism that would uphold intellectual values. Capitalism, he said, valued work too highly and true leisure too little. He disliked jazz, so when Hitler banned it in the 1930s, he didn't object. But Adorno proposed no way of achieving the culture he preferred except to legislate his tastes and ban all the choices he disliked. This appealed to people who shared his view. But many preferred American pop culture, whenever they had the right to choose.

Capitalism permits choices and the freedom to make them. Some radio stations play jazz, some offer opera and symphonies, others play pop music. Advertisers choose what radio or television shows to sponsor. Under socialism, the public watches and hears what someone else chooses for them and are allowed little individual choice.

The Templeton Foundation recently publicized various responses prominent intellectuals gave to the question: "Does the free market corrode moral character?" Several noted that free markets require a legal and political framework and the rule of law. One blot upon the morality of law by democratic choice is the legality, up to the 19th century, of slavery. Public opinion, a bloody war, and, finally, the law eventually removed that stain, and still another century would elapse before the law forbade race discrimination.

Most respondents took a mixed stand. The philosopher John Gray admitted that greed and envy were driving forces under capitalism but also produced growth and raised living standards, thus benefitting many. Greed also produces Enrons and WorldComs, but it is less a characteristic of a system than a vice of individuals, and it is at least as prevalent under socialism. Michael Walzer thought political activity also corrodes moral character but claimed that political activity was regulated more effectively. Another respondent thought the question had to be weighed relative to other social systems, and Bernard-Henri Levy asserted that alternatives to capitalism such as fascism and communism were far worse.

None mentioned Kant's view of mankind as consisting of a range of individuals of varying moral character. Institutional social arrangements such as democracy and capitalism appear to correlate with more morality in that no democratic capitalist country has produced crimes of a scale comparable to the mass murders committed by Hitler's Germany, Mao's China, or Lenin and Stalin's Soviet Union.

As Lord Acton warned, power corrupts. Some use power to impose their will, while proclaiming that noble ends justify the use of force or even tyranny to control the opposition. Communism proclaimed a vision of equality of outcome that it never came close to attaining. Individuals differ about what is good for themselves, so that a particular type of equality is difficult if not impossible to achieve without considerable dissatisfaction. After every national election, the dissatisfied voters include both those who wanted more redistribution and higher tax rates and those who wanted the opposite.

Kant's principle warns that utopian visions are unattainable. Capitalism does not offer a static vision of perfection and harmony. Democratic capitalism combines freedom, opportunity, growth, progress, and competition with restrictions on less desirable behavior. It creates societies that treat men and women as they are, not as in some utopian vision. In *The Open Society and Its Enemies* (1945), Karl Popper showed why utopian visions become totalitarian—because the state becomes obsessed with preventing all deviations from the utopian ideal.

The Enrons, WorldComs, and so forth show that dishonest individuals rise along with honest individuals. A scandal uncovered or a political promise unfulfilled hardly signifies that capitalism has failed, however, although it is true that after 25 to 40 years of talk, promises, and proposals about energy, education, health care, and cocaine and other drugs, little if any progress is visible on these issues.

In the last years we have seen major errors by government or its agents. For example, the Federal Reserve "rescued" American International Group (AIG) by using billions of taxpayer dollars, yet AIG had three profitable divisions, including a highly successful insurance company. Soon after, the taxpayers paid to keep General Motors and Chrysler from bankruptcy, though bankruptcy court would have been a better outcome for bondholders. Even if the companies repay the advances, the system will suffer because some large firms will take on excessive risk expecting to be spared if losses occur. Last August, the government lost six nuclear warheads (which were later found on B-52 bombers flying over the United States). Congress approved purchases of ethanol made from corn that raised the world price of food but did not reduce pollution. Government promises to pay for old-age pensions and health care far exceed any feasible revenues to pay for those promises, and Congress fails to develop a feasible plan. The estimated present value of the nation's unfunded health care promises is $70 to $80 trillion dollars. No private plan would be allowed to operate this way.

GROWTH AND PROGRESS

After World War II, especially after 1960, the developed countries led by the United States worked to raise growth rates in poor countries of the world. There were two experiments. The former Soviet Union and its fellow Communist countries controlled property and directed resource use according to plans developed by a central bureaucracy. Capitalist countries relied on opening to the international market and resource allocation based on market demand and individual choice.

The historic results are clear. Capitalism and the market system proved much more effective at development and reducing poverty than planning systems either in India, whose government is democratically chosen but previously socialist (many of India's leaders having been taught by socialist professors at the London School of Economics), or in authoritarian regimes such as the Soviet Union or China. There is not a single example of sustained successful growth under traditional Communism. The contrast was clear by the end of the 1980s in the comparison between North and South Korea, East and West Germany, and China compared to the Chinese diasporas of Asia.

Recent research charts national economic growth as a function of 38 observable components in five categories as a proxy for relative freedom versus socialism: size of government, legal structure, access to sound money, openness to trade and exchange, and regulation (Gwartney and Larson, 1996). Gwartney and Larson found that in countries with higher rates of investment, higher productivity growth, more foreign direct investment, and stricter adherence to the rule of law, per capita income rose at a compound rate of 3.44 percent in the freest countries, compared to average growth of 0.37 percent in "not free" countries. Intermediate countries had intermediate growth, 1.67 percent.

The failure of alternatives to capitalism and free markets is shown most strikingly by those systems' abandonment by India, China, and most of the former Communist world, who have seen a sustained, dramatic reduction in poverty after finally joining the world trading system and encouraging private ownership of resources, including capital. Many more people improved their living standards since 1990 than in 50 years of government planned development, regulation, and centrally directed resource allocation. Capitalism and the market have proved far better than the state at reducing poverty and raising living standards. Once this development became clear, perennial critics of capitalism turned to other reasons to oppose it. In her book, Margaret Thatcher (1993, p. 625) described such critics' reaction to her success at reforming the British economy, increasing productivity, and reducing inflation.

> Deprived for the moment at least of the opportunity to chastise the Government and blame free enterprise capitalism for failing to create jobs and raise living standards, the left turned their attention to non-economic issues. The idea that the state was the engine of economic progress was discredited—and even more so as the failures of communism became more widely known. But was the price of capitalist prosperity too high? Was it not resulting in gross and offensive materialism, traffic congestion and pollution? . . .
>
> [W]as not the 'quality of life' being threatened?
>
> I found all this misguided and hypocritical. If socialism had produced economic success the same critics would have been celebrating in the streets.

Socialism as a development model faces several obstacles. One is the reduced ability to recognize mistakes and act on that knowledge. A venture capitalist knows all of his investments won't succeed, so he must decide whether to advance more capital or close the firm. The capitalist facing the loss of his own investment decides based on his estimate of expected future return. The socialist uses different criteria. Admitting error is personally costly and requires layoffs. Faced with uncertainty about future outcomes, the socialist and the capitalist choose different outcomes when faced with a risk of shutting down an enterprise that may become profitable and the risk of supporting a failing enterprise. Workers, voters, lose employment. On average the capitalist, rather than the socialist, is more willing to close. The concentration of successful innovation in capitalist countries suggests that the capitalist strategy produces better results for society, as well as for investors and workers over the long run.

Capitalism rewards innovators, so it encourages innovation from anyone willing to invest in new ideas. Competitive markets drive improvements in product and output. Socialism concentrates decision making in a small group. Fewer new ideas develop. The freedom to fail or to gain that drives innovation, change, and progress is absent from the socialist structure. Capitalism without failure is like religion without sin. It doesn't work well.

Some innovations might be inconsistent with religious or moral standards. Critics of capitalism seize upon these arguments to condemn the choices that capitalism and freedom permit and instead promote their own preferences in place of market-driven choices. Democratic systems don't sustain unpopular rules meant to control the public's choices for very long.

Socialism, or any system based on an orthodoxy or a plan for the promotion of the "good," inevitably begins with persuasion and ends with coercion. Any deviation from orthodoxy is a step away from "the good." Hayek's *Road to Serfdom* (1944) showed why government planning is inconsistent with democratic choice.

The consistent, repeated failure of all types of socialist planning and state ownership of the means of production is now widely recognized. Critics of capitalism and promoters of alternatives now focus on advocating a welfare state, thereby transferring decisions to a bureaucracy. During the prosperous years after World War II, voters in all developed capitalist economies chose to increase redistribution, mainly by regulating, taxing, and spending.

INCOME DISTRIBUTION

The distribution of income is a major policy issue in every democratic capitalist nation's elections. There are fewer rich than poor or middle class. Fifty percent of the votes decide an election. The income of the median voter lies below the mean income, so a majority of voters can redistribute income. Early in the history of the American republic, Alexis de Tocqueville warned about the temptation for the voting majority to tax the incomes of those above the mean. His warning remains relevant. There are many examples of redistributive policy carried out for the benefit of the poor. One problem is that the poor are not the same as the lowest 10 or 20 percent of the statistical income distribution. People can be in the lowest tail temporarily. Also many of the poor do not vote. Older people and middle income people do, and they get more attention from politicians.

Angus Maddison, the leading researcher on the history of economic growth, found that by the year 1000 Asian countries led all others in per capita income. By 1820, the capitalist economies of Western Europe and the United States reached twice the Asian average. By 1950, the difference was wider.

Several Asian countries then adopted capitalist methods and the gap narrowed. After Japan and South Korea demonstrated to Asia that growth was a capitalist, not a Western, force, other nations followed, eventually including China and India.

Critics often complain about the gap in income between highest and lowest income groups. U.S. data show that since 1975, household income at the 90th percentile (in 2003 dollars) rose faster than household income at the 10th highest percentile in every five year period except 1990–95. Relative (real) income of the 90th percentile rose from 10.8 times the 10th percentile to 13.7 times. Comparisons that use median household income are misleading, however, because more households today have only a single person (earner) or a retired single person.

Sweden is often used as a model of humane capitalism. There is no doubt that Sweden tried hard to redistribute income. In 1975 the top 1 percent of consumer units received 2.8 percent of real disposable income. By 2000, the top 1 percent increased its share to 8.8 percent.[1] A recent comprehensive study of Swedish income distribution during the 20th century concluded: "Our findings suggest that top income shares in Sweden, like many other Western countries, decreased significantly over the first eighty years of the century. . . . Most of this decrease happened before 1950, that is, before expansion of the Swedish welfare state. As in many other countries, most of the fall was due to decreasing shares in the very top (the top one percent), while the income share of the lower half of the top decile . . . has been extraordinarily stable. Most of the fall is explained by decreased income from capital" (Roine and Waldenstrom, 2006, p. 24).

Income redistribution is easier for activist states to promise than to achieve. Many countries have tried, but

Roine and Waldenstrom show that the broad contour of the share of the top percentile is very similar in the seven countries they examined. Country efforts to redistribute had much less effect than broad tendencies. All countries experienced a large decline in the share of the top decile from about 1910 to 1980. The range drops from 20 to 25 percent to 5 to 10 percent in 1980. This is followed by a rise. By 2004, major differences appear, perhaps reflecting the importance of new technology and level of educational attainment in different countries. The top decile received about 15 percent in the United States and 13 percent in Canada and the United Kingdom, but about 8 percent in Sweden and 5 percent in the Netherlands. Chart 1.1 shows the decline in the share received by the top percentile.

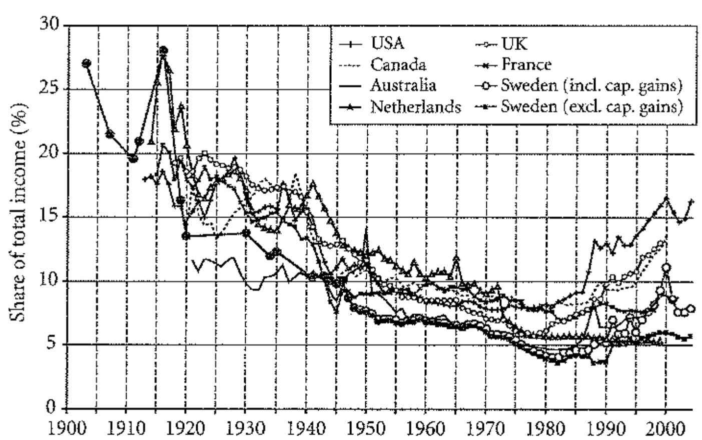

CHART 1.1 *Notes and Sources*: Australia (Atkinson and Leigh, 2006), Canada (Saez and Veall, 2005), France (Piketty, 2003), Netherlands and the United Kingdom (Atkinson and Salverda, 2005), and the United States (Piketty and Saez, 2003).

Data on income distribution have many flaws: people underreport and accurate sampling is difficult; the share of income from capital varies across countries; and people move within the distribution, so the lowest 10 percent and the highest 10 percent are not the same people over time. Careful research on U.S. distribution shows that in 2007 the group with lowest incomes had average wealth that put them in the fourth quintile of the wealth distribution, 61 to 80 percent. Their loss and negative income resulted from business and wealth losses (Diaz-Gimenez et al., 2011, p. 9). The proportion of divorced, separated, or single mothers has increased, with the lowest 10 percent disproportionately of this kind. Their relative poverty cannot be blamed on capitalism, although capitalist growth may have facilitated choices that led to this outcome.

Educational attainment increased in importance to income in the latter part of the 20th century. Low educational attainment and broken family structure are related. The spread in educational attainment works not only to cause growth but to spread the income distribution.

In 2003, the Organization for Economic Cooperation and Development surveyed attitudes and outcomes in the United States and some European countries. Americans worked more hours, experienced substantially lower unemployment rates, and lived in houses with nearly twice the space. The Europeans had much more extensive welfare states, but the Americans were far more satisfied with their lives. When asked: "How satisfied are you with your life?," 57 percent of the Americans answered "very."

In France, Germany, and Italy only 14 to 17 percent gave that answer. Slightly higher percentages answered "not very or not at all." Only 8 percent of Americans gave that answer.

CONCLUSION

Capitalism is not a utopian system, but there is no better system for providing growth and personal freedom. Capitalism's known alternatives offer less freedom and lower growth, and the "better alternatives" people imagine are almost always someone's idea of utopia. Libraries are full of books on utopia, and those that have been tried have either not survived or not flourished. The most common reason for failure is that one person's or one group's utopian ideal is unsatisfactory for others who live subject to its rules. Either the rules change or they are enforced by authorities. Capitalism, particularly democratic capitalism, gains support because it provides a means for orderly change in government. Choice is one of freedom's most valued attributes.

Critics of capitalism seek viable alternatives to support but usually fail to recognize that, unlike socialism, capitalism is adaptive, not rigid. Private ownership of the means of production flourishes regardless of culture. Capitalism's critics have recently discovered Chinese capitalism to propose as an alternative to American capitalism, whose main feature is mercantilism and rigid controls on capital. China's progress exploits international free trade—and the willingness of the United States to run a current account payments deficit. China is more authoritarian than Japan or the West, as Meiji Japan, Korea, and Taiwan also were in the past, and it lacks the rule of law, which is critical for the protection of personal and property rights. Growth produces a middle class, followed by demands for political freedom. China is in the early stages of development following the successful path pioneered by Japan, Korea, Taiwan, Hong Kong, and others who chose export-led growth under trade rules. Sustained economic growth led to social and political freedom in Japan, Korea, and Taiwan. Perhaps China will follow. No country has sustained economic growth without adopting the rule of law. Perhaps China will be the first. More likely it will not. Either freedom will increase as in Korea and Taiwan or growth rates will fall.

A large part of China's high growth rate results from movement of workers from low productivity in agriculture to manufacturing. If Chinese statistics can be believed, mobility from farm to factory accounts for about three-fourths of the growth rate. When that ends, as it will, the Chinese growth rate will decline substantially, as in Japan.

China faces another restriction on future growth. Restrictions on freedom limit innovation. Open democratic capitalist systems generate new ideas, new technologies, and new industries. Restrictions on freedom will limit China's long-term growth by suppressing initiative and innovation. It is not enough to train engineers; progress requires freedom to innovate.

Capitalism continues to spread. Instead of ending, as some critics suppose, capitalism has spread to cultures as different as Brazil, Chile, China, Japan, and Korea. It is the only system humans have found in which personal freedom, progress, and opportunities coexist. Most of the faults and flaws on which critics dwell are human faults, as Immanuel Kant recognized. Capitalism is the only system that adapts to all manner of cultural and institutional differences. It continues to spread and adapt and will continue to do so for the foreseeable future as long as people value both growth and freedom.

NOTES

1 Source: Statistics Sweden.

REFERENCES

Diaz-Gimenez, J., A. Glover, A., and J.-V. Rios-Rull. 2011. "Facts on the Distribution of Earnings, Income, and Wealth in the United States: 2007 Update." *Quarterly Review*, 34, Federal Reserve Bank of Minneapolis, February, 2–31.

Gwartney, J., and R. Larson. 1996. *Economic Freedom of the World*. Washington, DC: Cato Institute.

Hayek, Friedrich (1944). *The Road to Serfdom*. Chicago, University of Chicago Press.

Kant, Immanuel. 1784. "Ideas for a Universal History with a Cosmopolitan Purpose." Quoted in Isaiah Berlin (1990), *The Crooked Timber of Humanity: Chapters in the History of Ideas*. Princeton: Princeton University Press.

Meltzer, A. H., and Scott F. Richard. 1981. "A Rational Theory of the Size of Government." *Journal of Political Economy*, 89 (October), 914–927.

Peltzman, Sam. (2004). *Regulation and the Natural Progress of Opulence*. Washington, DC: AEI-Brookings Joint Center for Regulatory Studies.

Popper, Karl (1945). *The Open Society and Its Enemies*. London: Routledge.

Roine, Joseph, and Daniel Waldenstrom. 2006. "The Evolution of Top Incomes in an Egalitarian Society: Sweden, 1903–2004." Stockholm: Stockholm School of Economics, unpublished.

Thatcher, Margaret (1993). *The Downing Street Years*. New York: Harper Collins.