Testimony of Bruce R. Scott
Paul W. Cherington Professor of Business Administration,
Harvard Business School

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US Capitalism: a system of governance is challenged

Mr. Chairman and members of the Committee:

I am a faculty member of the Harvard Business School, and have been for many years. My initial field of study was in General Management, meaning the strategies and governance of firms. I migrated from that field to its analog at the country level in the 1960s while studying French attempts to formally plan their economic development.

In recent years I have been working on a book entitled *Capitalism, Democracy and Development*.[1] The title of the book is indicative of a shift in my own thinking from a focus on substantive economic strategies of countries to a focus on the processes of governance. From my comparative case studies on countries it has gradually become clear to me that much of a nation's economic strategy is embedded in the institutions through which that particular nation is governed, and that the existence of institutions imply a certain strategy. For instance, deregulation in the US as practiced since 1980 was a strategy designed to promote efficiency but it was also designed to favor capital at the expense of labor. Likewise, tolerance for the omission of the cost of stock options from profit and loss statements was nominally a way to promote performance, but also implicitly a strategy for redistributing wealth in favor of those with the power to secure grants of such options.

In this paper I will introduce several ideas from my book and then append some pages of explanation from two chapters of the text.

Capitalism is a system of governance

If there is one idea that I would urge this committee to consider in its studies of the off-shoring process, it is to go beyond a focus on markets to consider how capitalism works as a system of governance for economic affairs. Markets are part of that system of governance, with the invisible hand acting as an automatic form of governance within the prescribed frameworks of the markets. But markets are only part of the system, and a dependent part at that. All formal or organized markets require laws, regulations and

[1] Scheduled for publication later this year by Springer Verlag, Heidelberg.

physical and social institutions for their underpinnings. These laws and institutions are created through human agency and as a result they are likely to differ in significant aspects from one nation to another. These institutional variances imply that there are different variants of capitalism, and this in turn implies that the so-called Anglo-American style of capitalism is but one style. We should not assume that other countries are trying to be more like us unless we have sound empirical research to so indicate. In the meantime, we should pay close attention to the idea that capitalism is a system of governance where other countries could have economic strategies quite different from our own.

Gabriel Almond, a professor of political science at Stanford and former president of the American Political Science Association, called attention to this notion of capitalism as a system of governance when he wrote that the economy and the polity are the two chief problem-solving systems of a society, interacting with and transforming each other, as suggested in Slide number one. Almond's idea was expressed in an article in *Political Science and Politics* titled "Capitalism and Democracy" and thus I understand "economy" and "polity" to more specifically reference "capitalism" to "democracy," respectively. Thus, in his view and mine as well, capitalism refers to something very different from globalization--and if today you frame your inquiry in terms of the former, meaning comparative capitalist systems, your inquiry may take you in quite a different direction.

To explain: Globalization refers to the integration of markets, and market integration is being driven by very powerful forces such as declining transport costs and trade barriers, as we all know. Firms operate within markets and are greatly influenced by the forces of supply and demand that are manifested within them. Firms must learn to adjust to those market forces if they are to survive, let alone prosper. However, the market frameworks themselves are created, legitimated, monitored and periodically modernized by government and not by economic actors. To frame your inquiry in terms of how globalization works will risk ignoring how the markets have been structured and how these structures determine the actual operations that take place within the markets.

The market frameworks that facilitate and constrain economic activity are created through legislatures; as a result, they reflect the relative power of different interest groups in the political markets of legislatures at any point in time, as you all know better than I. It is legislative markets that create the frameworks within which firms operate, and the frameworks that underpin economic markets can be tilted to favor capital versus labor or the reverse, producers versus consumers, lenders versus creditors, and so on. The notion that the economic markets of capitalism somehow reflect a benign set of circumstances where parties voluntarily come together to achieve mutually beneficial transactions may be an adequate description of commerce at a roadside fruit and vegetable stand or a flea market, but not for much of the transactional activity of a modern economy. This notion of a benign, self regulating capitalism where almost all transactions are voluntary and therefore mutually beneficial is based upon an unexamined assumption that the legislative markets have done their job in a flawless way to begin

with, which would be quite remarkable if true. Thus, as a more realistic alternative I suggest that we see capitalism as a three level system of governance which is designed to mediate commerce among actors with different purposes, different access to information, and radically different access to economic power as well.

Capitalism as a three level system of governance

Capitalism is a concept which has been used to describe processes of governance that are partly political, partly legal and partly economic, and which interact in a system or systems that continue to evolve through time. It is not surprising that such a complex system has defied any standard definition for more than a century and that many books that analyze capitalist development do not even attempt to define it.[2] Given this situation, I have found it very helpful to define capitalism relative to some much smaller, simpler and more tractable governance systems, notably those for organized sports Thus, as shown in Slide number two, I define capitalism as an indirect, three level system for the governance of economic activities analogous to those used to govern team sports such as baseball, basketball, football and hockey. As in the governance of these sports, the essential principle is that the economic agents, like their analogs in sports, are free to use their powers as they wish, whether as individuals or as members of a firm, so long as they stay within the physical bounds of the competitive arena, and so long as they obey the rules and regulations of their particular capitalist system. I spell these ideas out more fully in three excerpts from Chapter 2 of my book, which are attached.

Crudely put, the three levels consist of the economic markets, the legal and other institutions that underpin those markets, and the political level through which new institutions are created and older ones maintained and modified. These three levels permit the harnessing of human energy that is called forth through competition, whether among sports teams, firms or individuals. The actions of the competitors are coordinated in part by their own social organizations (teams or firms) and in part by the rules, regulations and institutions that govern the competition, but in any event not by an immediate hierarchical authority with or without a central plan. Hence capitalism is an indirect system of governance, in contrast to one that is governed directly through a hierarchy.

Slide number three shows the three level model in more detail, distinguishing the factor markets (e.g., those for land, labor, capital and intellectual property) from those for goods and services. The distinction is very important for two reasons. First, historically speaking, it was the establishment of factor markets and not the trade in product markets that was the hallmark of capitalism. While some scholars have claimed that the Aztecs had “capitalism” before the Spanish arrived, I disagree. In 1500 the Aztecs, like most of the known world, did not have free mobility for land or labor; they had feudalism and even forced labor instead. Trade was compatible with feudalism but free mobility of land

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[2] Cf. Fernand Braudel, Civilization and Capitalism, 1400-1800, Volume 2, page 237 for some of the history of definitions.

and labor were not. And, as we remember from Shakespeare's Shylock, returns on financial capital were not seen to be legitimate in Venice pre-1600.

The second reason for calling attention to the factor markets is that they are the frameworks for the development and trade of resources, and thus a prime area where a government can influence its developmental prospects. Governments can favor saving versus consumption, for instance, and a number of East Asian nations have had saving rates at more than twice the American level since World War II. This has allowed them to finance growth rates superior to ours without the need to be open to foreign capital, for example in China in recent decades. Higher saving rates can be achieved through restrictions on consumer credit, high down payments on consumer durables such as housing, or mandatory payroll saving plans such as those in Australia, Chile or Singapore, where money is automatically deducted from paychecks and deposited in defined saving plans. In addition, countries can have quite different distributions of incomes between wages and profits and can use wage reductions as a preferred way to achieve a result similar to devaluation of the currency.

Capitalist countries that believe in an active role for government can have active, government led or supported strategies, a concept that is quite alien to those who think that completely decentralized decision making is the sure route to optimal efficiency. For instance, government supported strategies can embark on attempts to accelerate the acquisition, adaptation, and production of new, typically higher technology products instead of remaining specialized in existing products, (e.g., the Taiwanese government successfully invested in semiconductor manufactures starting virtually from scratch).

Common property is key resource in most if not all capitalist systems

While capitalism is usually defined as a system based upon private property and free enterprise, this is a remarkable oversimplification. As already noted, it is based in part upon regulated enterprise and in part upon common access to certain resources, such as air, water, light, and use of land for purposes of transportation. Historically, capitalism was also associated with the abolition of common land for grazing purposes in order to improve efficiencies. The choices in how to deal with common resources can be seen in terms of a hypothetical common, symbolized in the green area of Slide number 4.

When common land is left unfenced or unregulated, the situation is ripe for what is known as "The Tragedy of the Common", i.e., the tragedy that arises when economic actors have unrestricted rights to the use of a common resource such as a pasture.[3] If unregulated, the actors (e.g., the farmers or shepherds) will have a tendency to keep adding more animals to their herds until they cause the overgrazing of the field and damage or even destroy it. Still more obviously, it will be difficult for such a group of actors, if they act as individual competitors, to maintain the fertility of the field let alone improve it, and thus it will be very difficult for them to improve its productivity over

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[3] The name comes from a paper by Garrett Hardin, an eminent biologist.

time. Thus, the availability of a common resource is a classic case where unregulated competition produces undesirable results.

However, it is also a problem which can be readily solved by putting a fence around the field, adding a gate, and having someone lock and/or guard the gate. Given an enclosed field, the agent in control of the gate can regulate the number of users and/or their frequency of usage, thereby avoiding the over usage that would destroy the usefulness of the field as a source of food. What this means is that the so-called "tragedy of the common" is only a concern for an *unregulated common*. But simple as it might sound to have a fence, a gate, a guard and some rules and regulations that limit usage by the various actors, no regulatory framework can be expected to work unless it has been established by a legitimate political authority that can back enforce its actions by coercive force if need be, unless it is one that starts out with coercive force and without legitimacy.

This simple example illustrates some of the critical forces at the heart of what is needed for effective regulation of any common resource, such as air, water, sunlight or access to a right of way for travel. And solutions might seem simple, but in reality they are not. In Britain, where the idea of enclosing the common has been much studied, the common areas were privatized over several centuries, typically by acts of Parliament, and typically by awarding the land in question to the nearby manor or large landowner. Thus, the Enclosure Acts that were credited with improving productivity through improved methods of farming were redistributing land in favor of the rich while impoverishing most of their neighbors. In addition, these same acts have been credited with creating the pauper class that helped energize the workshops that preceded the Industrial Revolution and then the much larger factories of the latter era.[4] Enclosing the common in a legitimate, effective, and socially "just" or "democratic" way is therefore quite a difficult task for any political authority to undertake.

These developments in Britain illustrate the close connection between the system of economic governance and its political counterpart. The small landowners symbolized by the small houses in Slide number 4 had no representation in Parliament until late in the 19th century, by which time the Enclosure Movement was long since over. Parliament was dominated by the great landowners even after the Great Reform Bill of 1832, so the landowners could simply vote to grant themselves the right to take the land legally.[5] This illustrates one of the great risks of capitalism; powerful people can use the system to appropriate common resources from their neighbors, all in the name of greater efficiency through privatization. Power passes back and forth between the economic system and the political, and concentrations of power in either can subvert normal processes in the other. However, redistributing the land among the peasantry in the small brown houses is no sure answer either. When tried in a number of countries, for example in Mexico when it broke up its *ejidos*, it was a recipe for creating farming plots that were too small to be viable, and thus it led to declining productivity and poverty.

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[4] See Karl Polanyi, the Great Transformation, Beacon Press.
[5] For a fascinating and famous account of these events see Karl Polanyi, The Great Transformation.

Market frameworks as a key common asset of capitalism

In my view one of the great common assets of capitalism is hidden right in plain sight. It is the market frameworks that underpin the various markets for factors of production as well as trade in goods and services. These market frameworks are expressed in laws, regulations, and, in many countries, the law books that explain precedents from previous cases. Since these frameworks originate in legislatures they are by definition common property. This is also the case for later supporting regulations and court decisions. And, if a legislature has truly met Abraham Lincoln's notion of governing the people *for* the people and not just *by* the people, then it has created a form of commonwealth as surely as if it had voted to authorize new schools or highways to benefit all, as expressed in Slide number 5.

The state and the firm

Firms have a somewhat different relationship to the state in the US than in many other industrial countries, and this difference is very germane to your inquiry into the off-shoring of activities by US firms. As noted in Slide number 6, in most countries firms are chartered by a single authority speaking for the nation. In contrast, in the US the Constitution did not give the federal government this power to charter firms, for fear that this power might make the central government appear so powerful that the Constitution itself would be rejected during the ratification procedure. This meant that there were initially 13 gates (i.e., the 13 states at the time) to the common of the US market during the colonial and early federal era. This governance structure suited the market of the time; transport costs were so high that, once one was away from navigable water, the US market amounted to something much closer to 13 distinct state markets and, indeed, many smaller markets than to a single, national market. In these circumstances, a state was granting authority to firms to operate in markets that might in reality be a good deal smaller than a state and thus able to be managed by the regulatory power of the state in question. US states typically granted these early charters for public purposes, such as for universities and canals, and, given their local monopoly power in chartering, could accordingly ask for something in return. Since capital was scarce and corporations were rare until the early 19th century, few, if any, issues over firm power arose. The corporation existed as a legal entity because of a grant of power from the state and was at the same time accountable to the state and its chartering standards.

As time passed and transport improved, trading radiuses grew larger, and there were more and more requests for charters to establish a legal vehicle more permanent than a partnership. At much the same time, the concept of limited liability was developed, increasing the value of and demand for charters for incorporation even more. In order to speed up the processing of such requests and reduce the corruption in the legislatures over who would be favored, the states gradually shifted to "general charters" that notably lacked specific, public purposes. This movement to the general charter without specific firm objectives and standards reduced the apparent dependence of the firm on the state. Accordingly, legal doctrine gradually evolved toward seeing the firm

as the beneficiary of a free contract with the state and, eventually, as a "free entity" altogether, as though firms and indeed capitalism were born from and existed independent of the state.

What this meant was that by the 1870s, as the railroads linked regional markets into a nationwide system, the nation had 30-40 gates or states admitting firms to the market. States competed for the funds generated by corporate taxes and thus raced to the bottom in issuing charters that granted generous terms to firms. It was a case where unregulated competition was clearly *not* in the public interest. And the clearest example came in 1888 when New Jersey decided to break ranks with the other states and authorized its firms to create holding companies to buy or merge with other (often rival) firms, no matter where these firms had been incorporated and no matter whether such growth would reduce industry competition. As New York and eventually other states followed New Jersey's lead, the gates to the national market or common were opened wide to quasi-monopoly capitalism. The following years were marked by a stampede of mergers and the creation of much larger firms. Indeed, this change in New Jersey law would undermine almost all regulation of firm behavior, facilitating a great change in the structure of US firms and industries, all of it aimed at larger size with the implication of much greater economic power. And though this changed the nature of interstate commerce dramatically, the US Congress had little or no say in the matter as it lacked the constitutional right to intervene in the chartering process.

President Theodore Roosevelt understood this imbalance of power and attempted to correct it by supporting proposals to create a federal right to charter or license firms, as is discussed in the attached excerpt from Chapter 13. However, neither he nor his successor, William Howard Taft, was successful. What this meant was that the US government had little right to regulate its own market prior to the passage of the 17th Amendment in 1914, an amendment which switched the selection of US Senators away from state legislatures in favor of direct election. This amendment was viewed as essential to establishing more adequate power in Washington to regulate the national market. Thanks to their extraordinary influence in state legislatures, the big firms had been able to ensure the appointment of enough Senators friendly to their interests to dramatically limit the regulatory powers of the federal government. Thus, the US market had become much like the unregulated common discussed earlier, except that the agents taking advantage of the situation were firms advised by lawyers and not poor shepherds or goat herds, as suggested in Slide number 7.

Today's global economy is much like the US in the later 19th century

In today's economy, nations and states charter firms to compete in a global common, but no chartering authority exists that wields the political power to impose rules on these global markets. While there are rules for trade, the chartering of financial firms in particular invites a race to the bottom to escape taxes as well as regulations. At the same time, some countries are imposing conditions on foreign firms as a condition for doing business in their countries. This issue is particularly important in

the case of a few very large countries, notably China. These countries, with priorities that favor rapid growth, are using national power to partner with US firms on the condition that the latter move some of their activities to China. These countries are behaving much the way New Jersey did in an earlier era, taking advantage of an inadequately regulated common.

In light of the inadequate regulation of the global markets for capital and technology movements, I suggest that you consider reopening the question of a federal charter or license for US firms as a way to specify certain requirements for behavior. For instance, a federal charter might state that any US firms may choose to work for stakeholder interests if they so choose, a choice that they already have, in fact, but often seem to not be aware of. This would be a weak form of guidance. I think it would be better to consider the establishment of a mandatory standard of stakeholder welfare. In addition to the fact that it would put US firms more nearly in step with some of the major European countries in this respect, I believe it would be a healthy step in its own right, in that it would help limit the steadily increasing inequalities of income in this country. And, as another possible standard, there could be a mandate that any incentive compensation, other than that taking the form of restricted stock that is held for at least five years, would be subject to a very high rate of taxation, so as to more nearly align managerial incentives with those of shareholders.

Incentive compensation systems should have a downside risk as well as upside potential, and the only way to achieve this will be by uniform regulation; otherwise, any firms that did so voluntarily would risk a loss of key employees. The incentives in our market framework have become very problematic in encouraging CEOs to take risks in circumstances where they are not subject to comparable down side consequences if they fail. The costs of failure are borne by shareholders, lower level employees and, on occasion, by taxpayers. Our market frameworks, like the pastoral common of old, need regulatory standards to reduce the likelihood of opportunistic behavior that inflicts losses on other users of the same common.

Thank you.