Good Capitalism, Bad Capitalism and Economic Growth

By

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Many assumed that when the Berlin Wall fell in 1989, “capitalism” had won the ideological cold war and that “communism” had lost. But this view is too simplistic. It is true that “capitalism” – defined as an economic system built on the private ownership of property – indeed did prevail, but even a cursory look around the world reveals many differences among the nearly 200 countries which recognize private property ownership.

We find it constructive to sort out the capitalist economies into four broad categories. While many economies will straddle more than one of these types, most can be usefully described as fitting just one. Perhaps most important, we believe that the following typology provides an important clue to the elusive question of why some economies grow more rapidly than others, especially looking to the future.

Oligarchic capitalism exists where power and money are concentrated in a small elite. It is the worst form of capitalism, not because of the extreme inequality in income and wealth that such economies tolerate, but because the elites do not promote growth as the central goal of economic policy. Instead, they fix the rules to maximize their own income and wealth. Oligarchic capitalism prevails in large parts of Latin America, the Arab Middle East, and Africa.

State-guided capitalism describes economies where growth is a central economic objective (as it is in the other two forms of capitalism to be described next), but attempts to achieve it by favoring specific or industries. Governments do this by allocating credit (through direct bank ownership or by guiding credit decisions by privately owned banks), providing direct subsidies and/or tax incentives, granting trade protection, or through other regulatory means.

Southeast Asian economies have demonstrated great success with state guidance, and until the late 1990s, there were calls in the United States to emulate their practices. But the Achilles heel of state guidance is that as economies approach the frontier, they run out of industries and technologies to copy. When government officials rather than markets then try to “pick winners” they run a great danger of choosing the wrong ones, or channeling too much investment – and thus excess capacity – into existing sectors. Such a tendency contributed importantly to the Asian financial crisis of 1997-98.

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Big Firm or *managerial capitalism* characterizes economies where production and employment is dominated by large firms, and often "national champions." Smaller enterprises exist, but these are typically retail or service establishments with one or only a few employees. Firms get to be large by exploiting economies of scale, refining and mass producing the radical innovations developed by entrepreneurs (discussed next). Western European economies and Japan are leading exemplars of managerial capitalism, which like state guidance, also has delivered strong economic performance.

But managerial capitalism also has its Achilles heel. Bureaucratic enterprises are typically allergic to taking big risks, developing and commercializing the radical innovations that push out the production-possibility frontier and generate large sustained jumps in productivity and thus in economic growth. In our view, this is the reason why after approaching U.S. levels of per capita income in the late 1980s, both Western Europe and Japan failed to match the information-technology driven productivity resurgence of the 1990s experienced by the United States. In addition, economies dominated by large firms typically have "Galbraithian" institutions of countervailing power – big labor and/or big government – that can