

Capitalism After the Crisis

Luigi Zingales

THE ECONOMIC CRISIS of the past year, centered as it has been in the financial sector that lies at the heart of American capitalism, is bound to leave some lasting marks. Financial regulation, the role of large banks, and the relationships between the government and key players in the market will never be the same.

More important, however, are the ways in which public attitudes about our system might change. The nature of the crisis, and of the government's response, now threaten to undermine the public's sense of the fairness, justice, and legitimacy of democratic capitalism. By allowing the conditions that made the crisis possible (particularly the concentration of power in a few large institutions), and by responding to the crisis as we have (especially with massive government bailouts of banks and large corporations), the United States today risks moving in the direction of European corporatism and the crony capitalism of more statist regimes. This, in turn, endangers America's unique brand of capitalism, which has thus far avoided becoming associated in the public mind with entrenched corruption, and has therefore kept this country relatively free of populist anti-capitalist sentiment.

Are such changes now beginning? And if so, will they mark only a temporary reaction to an extreme economic downturn, or a deeper and more damaging shift in American attitudes? Some early indications are not encouraging.

SOAK THE RICH

A friend of mine worked as a consultant for the now-infamous insurance giant American International Group. To prevent him from starting his

LUIGI ZINGALES is the Robert C. McCormack Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business, and co-author of Saving Capitalism from the Capitalists.

own hedge fund, AIG offered him a non-compete agreement: a sum of money meant to compensate him for the opportunity forgone. It is a perfectly standard and well-regarded practice—but unfortunately for my friend, his payment under this agreement was to be made at the end of 2008. So he spent the early months of 2009 living in terror: His contract was classified as one of the notorious AIG retention bonuses. At the height of the fury against those bonuses, he received several death threats. Though he had no legal obligation to do so, he returned the money to the company, hoping that the gesture might keep his name from being published in the papers. In case that failed to protect him, he prepared a plan to evacuate his wife and children. It was the responsible thing to do; after all, angry protestors had staked out the homes of several AIG executives whose names appeared in print—and only luck had prevented someone from getting hurt.

While such extreme episodes have, fortunately, been quite rare, they are symptomatic of a broad discontent. In one recent survey, 65% of Americans said the government should cap executive compensation by large corporations, while 60% wanted the government to intervene to improve the way corporations are run. And those views hardly reflect confidence in the government: Only 5% of Americans in the same poll said they trust the government a lot, while 30% said they do not trust it at all. It is just that, at the moment, Americans trust large corporations even less: Fewer than one out of every 30 Americans say they trust them a lot, while one of every three Americans claims not to trust large corporations at all.

These attitudes are familiar to students of public opinion in much of the world. But they are quite unusual for the United States. Until recently, Americans stood out for their acceptance of basic market principles and even for their tolerance of some of the negative side effects markets produce, such as marked income inequality.

Capitalism has long enjoyed exceptionally strong public support in the United States because America's form of capitalism has long been distinct from those found elsewhere in the world—particularly because of its uniquely open and free market system. Capitalism calls not only for freedom of enterprise, but for rules and policies that allow for freedom of entry, that facilitate access to financial resources for newcomers, and that maintain a level playing field among competitors. The United States has generally come closest to this ideal combination—which is

no small feat, since economic pressures and incentives do not naturally point to such a balance of policies. While everyone benefits from a free and competitive market, no one in particular makes huge profits from keeping the system competitive and the playing field level. True capitalism lacks a strong lobby.

That assertion might appear strange in light of the billions of dollars firms spend lobbying Congress in America, but that is exactly the point. Most lobbying seeks to tilt the playing field in one direction or another, not to level it. Most lobbying is *pro-business*, in the sense that it promotes the interests of existing businesses, not *pro-market* in the sense of fostering truly free and open competition. Open competition forces established firms to prove their competence again and again; strong successful market players therefore often use their muscle to restrict such competition, and to strengthen their positions. As a result, serious tensions emerge between a pro-market agenda and a pro-business one, though American capitalism has always managed this tension far better than most.

THE AMERICAN EXCEPTIONION

In a recent study, Rafael Di Tella and Robert MacCulloch showed that public support for capitalism in any given country is positively associated with the perception that hard work, not luck, determines success, and is negatively correlated with the perception of corruption. These correlations go a long way toward explaining public support for America's capitalist system. According to one recent study, only 40% of Americans think that luck rather than hard work plays a major role in income differences. Compare that with the 75% of Brazilians who think that income disparities are mostly a matter of luck, or the 66% of Danes and 54% of Germans who do, and you begin to get a sense of why American attitudes toward the free-market system stand out.

Some scholars argue that this perception of capitalism's legitimacy is merely the result of a successful propaganda campaign for the American Dream — a myth embedded in American culture, but not necessarily tied to reality. And it is true that the data yield scant evidence that social mobility is higher across the board in the United States than in other developed countries. But while this difference does not show up in the aggregate statistics, it is powerfully present at the top of the distribution — which often gets the most attention, and most shapes

people's attitudes. Even before the internet boom created many young billionaires, in 1996, one in four billionaires in the United States could be described as "self-made" — compared to just one out of ten in Germany. And the wealthiest self-made American billionaires — from Bill Gates and Michael Dell to Warren Buffett and Mark Zuckerberg — have made their fortunes in competitive businesses, with little or no government interference or help.

The same cannot be said for most other countries, where the wealthiest people tend to accumulate their fortunes in regulated businesses in which government connections are crucial to success. Think about the oligarchs in Russia, Silvio Berlusconi in Italy, Carlos Slim in Mexico, and even the biggest tycoons in Hong Kong. They made their fortunes in businesses that are highly dependent on governmental concessions: energy, real estate, telecommunications, mining. Success in these businesses often depends more on having the right connections than on having initiative and enterprise.

In most of the world, the best way to make money is not to come up with brilliant ideas and work hard at implementing them, but to cultivate a government connection. Such cronyism is bound to shape public attitudes about a country's economic system. When asked in a recent study to name the most important determinants of financial success, Italian managers put "knowledge of influential people" in first place (80% considered it "important" or "very important"). "Competence and experience" ranked fifth, behind characteristics such as "loyalty and obedience."

These divergent paths to prosperity reveal more than a difference of perception. American capitalism really is quite distinct from its European counterparts, for reasons that reach deep into history.

THE ROOTS OF AMERICAN CAPITALISM

In America, unlike much of the rest of the West, democracy predates industrialization. By the time of the Second Industrial Revolution in the latter part of the 19th century, the United States had already enjoyed several decades of universal (male) suffrage, and several decades of widespread education. This created a public with high expectations, unlikely to tolerate evident unfairness in economic policy. It is no coincidence that the very concept of anti-trust law — a pro-market but sometimes anti-business idea — was developed in the United States at the end of the

19th century and the beginning of the 20th. It is also no coincidence that in the early part of the 20th century, fueled by an inquisitive press and a populist (but not anti-market) political movement, the United States experienced a rise in regulation aimed at reducing the power of big business. Unlike in Europe—where the most vibrant opposition to the excesses of business came from socialist anti-market movements—in the United States this opposition was squarely pro-market. When Louis Brandeis attacked the money trust, he was not fundamentally trying to interfere with markets—only trying to make them work better. As a result, Americans have long understood that the interests of the market and the interests of business may not always be aligned.

American capitalism also developed at a time when government involvement in the economy was quite weak. At the beginning of the 20th century, when modern American capitalism was taking shape, U.S. government spending was only 6.8% of gross domestic product. After World War II, when modern capitalism really took shape in Western European countries, government spending in those countries was, on average, 30% of GDP. Until World War I, the United States had a tiny federal government compared to national governments in other countries. This was due in part to the fact that the U.S. faced no significant military threat to its existence, which allowed the government to spend a relatively small proportion of its budget on the military. The federalist nature of the American regime also did its part to limit the size of the national government.

When the government is small and relatively weak, the way to make money is to start a successful private-sector business. But the larger the size and scope of government spending, the easier it is to make money by diverting public resources. Starting a business is difficult and involves a lot of risk—but getting a government favor or contract is easier, and a much safer bet. And so in nations with large and powerful governments, the state tends to find itself at the heart of the economic system, even if that system is relatively capitalist. This tends to confound politics and economics, both in practice and in public perceptions: The larger the share of capitalists who acquire their wealth thanks to their political connections, the greater the perception that capitalism is unfair and corrupt.

Another distinguishing feature of American capitalism is that it developed relatively untouched by foreign influence. Although European (and especially British) capital played a significant role in America's

19th- and early 20th-century economic development, Europe's economies were not more developed than America's—and so while European capitalists could invest in or compete with American companies, they could not dominate the system. As a result, American capitalism developed more or less organically, and still shows the marks of those origins. The American bankruptcy code, for instance, exhibits significant pro-debtor biases, because the United States was born and developed as a nation of debtors.

The situation is very different in nations that developed capitalist economies after World War II. These countries (in non-Soviet-bloc continental Europe, parts of Asia, and much of Latin America) industrialized under the giant shadow of American power. In this development process, the local elites felt threatened by the prospect of economic colonization by American companies that were far more efficient and better capitalized. To protect themselves, they purposely built a non-transparent system in which local connections were important, because this gave them an inherent advantage. These structures have proven resilient in the decades since: Once economic and political systems are built to reward relationships instead of efficiency, it is very difficult to reform them, since the people in power are the ones who would lose most in the change.

Finally, the United States was able to develop a pro-market agenda distinct from a pro-business agenda because it was largely spared the direct influence of Marxism. It is possible that the type of capitalism the United States developed is the cause, as much as the effect, of the absence of strong Marxist movements in this country. But either way, this distinction from other Western regimes was significant in the development of American attitudes toward economics. In countries with prominent and influential Marxist parties, pro-market and pro-business forces were compelled to merge to fight the common enemy. If one faces the prospect of nationalization (i.e., the control of resources by a small *political* elite), even relationship capitalism (which involves control of those resources by a small *business* elite) becomes an appealing alternative.

As a result, many of these countries could not develop a more competitive and open form of capitalism because they could not afford to divide the opposition to Marxism. Worse, the free-market banner was completely appropriated by the pro-business forces, which were better equipped and better fed. Paradoxically, as the appeal of Marxist ideas

faded, this problem in many of these countries became worse, not better. After decades of contiguity and capture, the pro-market forces could not separate themselves from the pro-business camp. Having lost the ideological opposition of Marxism and lacking any opposition from pro-market ideology, pro-business forces ruled unchecked. In no country is this more evident than in Italy, where the pro-market movement today is almost literally owned by a businessman, Prime Minister Silvio Berlusconi, who often seems to run the country in the interest of his media empire.

For all these reasons, the United States developed a system of capitalism that comes closer than any other to the ideal combination of economic freedom and open competition. The image many Americans have of capitalism is therefore that of Horatio Alger's rags-to-riches-via-hard-work stories, which have come to define the American Dream. By contrast, in most of the rest of the world, Horatio Alger is unknown—and the image of social mobility is dominated by Cinderella or Evita stories: fantasies more than plausible dreams. This understanding of opportunity has helped make capitalism popular and secure in the United States.

But because the free-market system relies on this public support, and this support depends to a certain extent on the public's impression that the system is fair, any erosion of that impression threatens the system itself. Such erosion occurs when government connections, or the power of entrenched incumbents in the market, seem to overtake genuine free and fair competition as the paths to wealth and success. Both government and big business have strong incentives to push the system in this direction, and therefore both, if left unchecked, pose a threat to America's distinctive form of capitalism.

Although the United States has the great advantage of having started from a superior model of capitalism and having developed an ideology to support it, our system is still vulnerable to these pressures—and not only in a crisis. Even the most persuasive and resilient ideology cannot long outlive the conditions and reasoning that generated it. American capitalism needs vocal defenders who understand the threats it faces—and who can make its case to the public. But in the last 30 years, as the threat of global communism has waned and disappeared, capitalism's defenders have grown fewer, while the temptations of corporatism have grown greater. This has helped set the stage for the crisis we now face—and left us less able to discern how we might recover from it.

THE DEMISE OF AMERICAN EXCEPTIONALISM

A healthy financial system is crucial to any working market economy. Widespread access to finance is essential to harnessing the best talents and allowing them to prosper and grow. It is crucial for drawing new entrants into the system, and for fostering competition. The system that allocates finance allocates power and rents; if that system is not fair, there is little hope that the rest of the economy can be. And the potential for unfairness or abuse in the financial system is always great.

Americans have long been sensitive to such abuse. While we have historically avoided general anti-capitalist biases, Americans have nonetheless nurtured something of a populist anti-finance bias. This bias has led to many political decisions throughout American history that were inefficient from an economic point of view, but helped preserve the long-term health of America's democratic capitalism. In the late 1830s, President Andrew Jackson opposed renewing the charter of the Second Bank of the United States—a move that contributed to the panic of 1837—because he saw the bank as an instrument of political corruption and a threat to American liberties. An investigation he initiated established “beyond question that this great and powerful institution had been actively engaged in attempting to influence the elections of the public officers by means of its money.”

Throughout much of American history, state bank regulations were driven by concerns about the power of New York banks over the rest of the country, and the fear that big banks drained deposits from the countryside in order to redirect them to the cities. To address these fears, states introduced a variety of restrictions: from unit banking (banks could have only one office), to limits on intrastate branching (banks from northern Illinois could not open branches in southern Illinois), to limits on interstate branching (New York banks could not open branches in other states). From a purely economic point of view, all of these restrictions were crazy. They forced a reinvestment of deposits in the same areas where they were collected, badly distorting the allocation of funds. And by preventing banks from expanding, these regulations made banks less diversified and thus more prone to failure. Nevertheless, these policies had a positive side effect: They splintered the banking sector, reducing its political power and in so doing creating the preconditions for a vibrant securities market.

Even the separation between investment banking and commercial banking introduced by the New Deal's Glass-Steagall Act was a product of this longstanding American tradition. Unlike many other banking regulations, Glass-Steagall at least had an economic rationale: to prevent commercial banks from exploiting their depositors by dumping on them the bonds of firms to which the banks had lent money, but which could not repay the loans. The Glass-Steagall Act's biggest consequence, though, was the fragmentation it caused—which helped reduce the concentration of the banking industry and, by creating divergent interests in different parts of the financial sector, helped reduce its political power.

In the last three decades, these arrangements were completely overturned, starting with the progressive deregulation of the banking sector. The restrictions imposed by state regulations were highly inefficient to begin with, but over the years technological and financial progress made them absolutely untenable. What good does it do to restrict branching when banks can set up ATMs throughout the country? How effectively can a prohibition on intrastate branching block the redistribution of deposits, when non-integrated banks can reallocate them through the interbank market?

So starting in the late 1970s, state bank regulations were relaxed or eliminated, increasing the efficiency of the banking sector and fostering economic growth. But the move also increased concentration. In 1980, there were 14,434 banks in the United States, about the same number as in 1934. By 1990, this number had dropped to 12,347; by 2000, to 8,315. In 2009, the number stands below 7,100. Most important, the concentration of deposits and lending grew significantly. In 1984, the top five U.S. banks controlled only 9% of the total deposits in the banking sector. By 2001, this percentage had increased to 21%, and by the end of 2008, close to 40%.

The apex of this process was the 1999 passage of the Gramm-Leach-Bliley Act, which repealed the restrictions imposed by Glass-Steagall. Gramm-Leach-Bliley has been wrongly accused of playing a major role in the current financial crisis; in fact, it had little to nothing to do with it. The major institutions that failed or were bailed out in the last two years were pure investment banks—such as Lehman Brothers, Bear Stearns, and Merrill Lynch—that did not take advantage of the repeal of Glass-Steagall; or they were pure commercial banks, like Wacho-

via and Washington Mutual. The only exception is Citigroup, which had merged its commercial and investment operations even before the Gramm-Leach-Bliley Act, thanks to a special exemption.

The real effect of Gramm-Leach-Bliley was political, not directly economic. Under the old regime, commercial banks, investment banks, and insurance companies had different agendas, and so their lobbying efforts tended to offset one another. But after the restrictions were lifted, the interests of all the major players in the financial industry became aligned, giving the industry disproportionate power in shaping the political agenda. The concentration of the banking industry only added to this power.

The last and most important source of the finance industry's growing power was its profitability, at least on the books. In the 1960s, the share of GDP produced by the finance sector amounted to a little more than 3%. By the mid-2000s, it was more than 8%. This expansion was driven by a rapid increase not only in profits, but also in wages. In 1980, the relative wage of a worker in the finance sector was roughly comparable to the wages of other workers with the same qualifications in other sectors. By 2007, the person in the finance sector was making 70% more. Every attempt to explain this gap using differences in abilities, or the inherent demands of the work, falls short. People working in finance were simply making significantly more than everybody else.

This enormous profitability allowed the industry to spend disproportionate amounts of money lobbying the political system. In the last 20 years, the financial industry has made \$2.2 billion in political contributions, more than any other industry tracked by the Center for Responsive Politics. And over the last ten years, the financial industry topped the lobbying-expenses list, spending \$3.5 billion.

The explosion of wages and profits in finance also naturally attracted the best talents—with implications that extended beyond the financial sector, and deep into government. Thirty years ago, the brightest undergraduates were going into science, technology, law, and business; for the last 20 years, they have gone to finance. Having devoted themselves to this sector, these talented individuals inevitably end up working to advance its interests: A person specialized in derivative trading is likely to be terribly impressed with the importance and value of derivatives, just as a nuclear engineer is likely to think nuclear power can solve all the world's problems. And if most of the political elite were picked

from among nuclear engineers, it would be only natural that the country would soon fill with nuclear plants. In fact, we have an example of precisely this scenario in France, where for complicated cultural reasons an unusually large portion of the political elite is trained in engineering at the *École Polytechnique* — and France derives more of its energy from nuclear power than any other nation.

A similar effect is evident with finance in America. The proportion of people with training and experience in finance working at the highest levels of every recent presidential administration is extraordinary. Four of the last six secretaries of Treasury fit this description. In fact, all four were directly or indirectly connected to one firm: Goldman Sachs. This is hardly the historical norm; of the previous six Treasury secretaries, only one had a finance background. And finance-trained executives staff not only the Treasury but many senior White House posts and key positions in numerous other departments. President Barack Obama's chief of staff, Rahm Emanuel, once worked for an investment bank, as did his predecessor under President George W. Bush, Joshua Bolten.

There is nothing intrinsically bad about these developments. In fact, it is only natural that a government in search of the brightest people will end up poaching from the finance world, to which the best and brightest have flocked. The problem is that people who have spent their entire lives in finance have an understandable tendency to think that the interests of their industry and the interests of the country always coincide. When Treasury Secretary Henry Paulson went to Congress last fall arguing that the world as we knew it would end if Congress did not approve the \$700 billion bailout, he was serious and speaking in good faith. And to an extent he was right: *His* world — the world he lived and worked in — would have ended had there not been a bailout. Goldman Sachs would have gone bankrupt, and the repercussions for everyone he knew would have been enormous. But Henry Paulson's world is not the world most Americans live in — or even the world in which our economy as a whole exists. Whether *that* world would have ended without Congress's bailout was a far more debatable proposition; unfortunately, that debate never took place.

Compounding the problem is the fact that people in government tend to rely on their networks of trusted friends to gather information “from the outside.” If everyone in those networks is drawn from the same milieu, the information and ideas that flow to policymakers will

be severely limited. A revealing anecdote comes from a Bush Treasury official, who noted that in the heat of the financial crisis, every time there was a phone call from Manhattan's 212 area code, the message was the same: "Buy the toxic assets." Such uniformity of advice makes it difficult for even the most intelligent or well-meaning policymakers to arrive at the right decisions.

THE VICIOUS CYCLE

The finance sector's increasing concentration and growing political muscle have undermined the traditional American understanding of the difference between free markets and big business. This means not only that the interests of finance now dominate the economic understanding of policymakers, but also—and perhaps more important—that the public's perception of the economic system's legitimacy is at risk.

If the free-market system is politically fragile, its most fragile component is precisely the financial industry. It is so fragile because it relies entirely on the sanctity of contracts and the rule of law, and that sanctity cannot be preserved without broad popular support. When people are angry to the point of threatening the lives of bankers; when the majority of Americans are demanding government intervention not only to regulate the financial industry but to control the way companies are run; when voters lose confidence in the economic system because they perceive it as fundamentally corrupt—then the sanctity of private property becomes threatened as well. And when property rights are not protected, the survival of an effective financial sector, and with it a thriving economy, is in doubt.

The government's involvement in the financial sector in the wake of the crisis—and particularly the bailouts of large banks and other institutions—has exacerbated this problem. Public mistrust of government has combined with mistrust of bankers, and concerns about the waste of taxpayer dollars have been joined to worries about rewarding those who caused the mess on Wall Street. In response, politicians have tried to save themselves by turning against the finance sector with a vengeance. That the House of Representatives approved a proposal to retroactively tax 90% of all bonuses paid by financial institutions receiving TARP money shows how dangerous this combination of backlash and demagoguery can be.

Fortunately, that particular proposal never became law. But the anti-finance climate that produced it greatly contributed, for instance, to

the expropriation of Chrysler's secured creditors this spring. By singling out and publicly condemning the Chrysler creditors who demanded that their contractual rights be respected, President Obama effectively exploited public resentment to reduce the government's costs in the Chrysler bailout. But the cost-cutting came at the expense of current investors, and sent a signal to all potential future investors. While Obama's approach was convenient in the short term, it could prove devastating to the market system over time: The protection afforded to secured creditors is crucial in making credit available to firms in financial distress and even in Chapter 11. The Chrysler precedent will jeopardize access to such financing in the future, particularly for the firms most in need, and so will increase the pressure for yet more government involvement.

The pattern that has taken hold in the wake of the financial crisis thus threatens to initiate a vicious cycle. To avoid being linked in the public mind with the companies they are working to help, politicians take part in and encourage the assault on finance; this scares off legitimate investors, no longer certain they can count on contracts and the rule of law. And this, in turn, leaves little recourse for troubled businesses but to seek government assistance.

It is no coincidence that shortly after bashing Wall Street executives for their greed, the administration set up the most generous form of subsidy ever invented for Wall Street. The Public-Private Investment Program, announced in March by Treasury Secretary Timothy Geithner, provides \$84 of government-subsidized loans and \$7 of government equity for every \$7 of private equity invested in the purchase of toxic assets. The terms are so generous that the private investors essentially receive a subsidy of \$2 for every dollar they put in.

If these terms are "justified" by the uncertainty stemming from the populist backlash, they also exacerbate the conditions that generated the backlash in the first place—confirming the sense that government and large market players are cooperating at the expense of the taxpayer and the small investor. If the Public-Private Investment Program works, the very people who created the problem stand to grow fabulously rich with government help—which will surely do no good for the public's impression of American capitalism.

This is just the unhealthy cycle in which capitalism is trapped in most countries around the world. On one hand, entrepreneurs and financiers

feel threatened by public hostility, and thus justified in seeking special privileges from the government. On the other hand, ordinary citizens feel outraged by the privileges the entrepreneurs and financiers receive, inflaming that very hostility. For anyone acquainted with the character of capitalism around the world, this moment in America feels eerily familiar.

THE FUTURE OF AMERICAN CAPITALISM

We thus stand at a crossroads for American capitalism. One path would channel popular rage into political support for some genuinely pro-market reforms, even if they do not serve the interests of large financial firms. By appealing to the best of the populist tradition, we can introduce limits to the power of the financial industry—or any business, for that matter—and restore those fundamental principles that give an ethical dimension to capitalism: freedom, meritocracy, a direct link between reward and effort, and a sense of responsibility that ensures that those who reap the gains also bear the losses. This would mean abandoning the notion that any firm is too big to fail, and putting rules in place that keep large financial firms from manipulating government connections to the detriment of markets. It would mean adopting a pro-market, rather than pro-business, approach to the economy.

The alternative path is to soothe the popular rage with measures like limits on executive bonuses while shoring up the position of the largest financial players, making them dependent on government and making the larger economy dependent on them. Such measures play to the crowd in the moment, but threaten the financial system and the public standing of American capitalism in the long run. They also reinforce the very practices that caused the crisis. This is the path to big-business capitalism: a path that blurs the distinction between pro-market and pro-business policies, and so imperils the unique faith the American people have long displayed in the legitimacy of democratic capitalism.

Unfortunately, it looks for now like the Obama administration has chosen this latter path. It is a choice that threatens to launch us on that vicious spiral of more public resentment and more corporatist crony capitalism so common abroad—trampling in the process the economic exceptionalism that has been so crucial for American prosperity. When the dust has cleared and the panic has abated, this may well turn out to be the most serious and damaging consequence of the financial crisis for American capitalism.