Saving capitalism from Economics 101

By Simon Johnson
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All across the United States, students are settling into college – and coming to grips with "Econ 101." This introductory course is typically taught with a broadly reassuring message: if markets are allowed to work, good outcomes – such as productivity growth, increasing wages, and generally shared prosperity – will surely follow.

Unfortunately, as my co-author James Kwak points out in his recent book, *Economism: Bad Economics and the Rise of Inequality*, Econ 101 is so far from being the whole story that it could actually be considered misleading – at least as a guide to sensible policymaking. Markets can be good, but they are also profoundly susceptible to abusive practices, including by prominent private-sector people. This is not a theoretical concern; it is central to our current policy debates, including important new US legislation that has just been put forward.

One core problem is that market incentives reward self-interested private behavior, without accounting for social benefits or costs. We generally overlook our actions' spillover effects on others, or "externalities." To be fair, Econ 101 textbooks do discuss this issue in some contexts, such as pollution, and it is widely accepted that environmental damage needs to be regulated if we are to have clean air, clean water, and limits on other pollutants.

Unfortunately, "widely accepted" does not include by President Donald Trump's administration, which is busy rolling back environmental protections across a broad range of activities. *The New York Times* counts 76 rollbacks in progress. The thinking behind this policy is straight out of the first few weeks of Econ 101: get out of the way of the market. As a result, there is a lot more pollution – including more emission of greenhouse gases – in America's future.

There is also an even deeper problem. There is a general presumption in Econ 101 that firms should maximize profits, and that this is best for their shareholders and for society. But this notion of "firms" is just a shorthand for people organized in a particular form. People, not firms, make decisions. To understand the nature and impact of these decisions, we need to look closely at the incentives of firms' senior managers and board members.

Since the 1970s, the people who run firms have become much more focused on increasing their compensation, through bonuses, stock options, and the like. There has been a significant rise in the value of shares, most of which are owned by the wealthiest 10% of Americans. At the same time, median wages have barely increased – a dramatic change from the immediate post-World War II period, when productivity increases led to steady wage gains.

Today, it is top managers and members of boards of directors in whose interest firms are run. Investors sometimes get a good ride, though there are plenty of instances where insiders take excessive advantage by awarding themselves overly generous compensation, taking on excessive risk, or engaging in other, more devious practices. The idea that compensation committees insist on genuinely impressive performance, relative to relevant benchmarks, has become risible.

This is the context in which Senator Elizabeth Warren of Massachusetts is proposing a new Accountable Capitalism Act. Very large companies would need to acquire a federal charter (as opposed to the current state charter arrangements), which would come with specific obligations – in particular, the need to consider the interests of all corporate stakeholders, including workers. To make this more meaningful and generally improve transparency, ordinary (non-management) employees should get some representation on the board of directors. This type of arrangement works well in Germany, a country where workers continue to be treated with respect.3

Warren also supports a proposal that originated from John Bogle, founder of Vanguard (a mutual fund company), that would require super-majority support from shareholders and directors before a large company could engage in political expenditures.

The underlying legal theory behind these proposals is sound, and it is well articulated in a letter signed by Robert Hockett of Cornell Law School and other distinguished figures. Large corporations are granted significant rights, including limited liability for individual executives, and facilitate the pooling of large amounts of capital from people who do not necessarily know one another (or the promoters of the company). Originally, the purpose was to enable the private sector to carry out large-scale risky investments that had broader potential impact, such as building canals and railroads.

The US supposedly constrains the activities of large corporations, with the Department of Justice taking action if companies acquire monopoly power or otherwise behave in an anti-competitive manner. Realistically, the enforcement of antitrust law has slipped a long way in recent years, under both Republican and Democratic administrations.

Warren is proposing a much broader rethink. Large corporations can still do well, but they need to be held accountable in a much more transparent way. Incentives for executives would be adjusted, and running these companies would no longer be so much about lining their own pockets. Workers would no longer be treated so badly, and more people might even start to believe again in the American Dream of prosperity for all.

The legitimacy of capitalism – private ownership and reliance on market mechanisms – would be greatly strengthened under the Accountable Capitalism Act. So, yes, like it or not, this will be on the final exam.

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