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THE NEW CAPITALISM

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When a successful investment banker turned Treasury Secretary caps his career by arranging a $700 billion bailout of the banking system after engineering the nationalization of two financial institutions so large that even the most doctrinaire socialist would have paused at the prospect of taking them onto the government’s balance sheet, when a leading neoconservative suggests, only partly in jest, that presidents of banks seeking to sell their dicey paper to the Treasury should not be allowed to earn more than the President of the United States ($400,000 annually), you know that something fundamental is going on. Which indeed, it is: the day has passed when that engine of capitalism, the financial market, will be allowed to operate more or less unimpeded by government.

True, we have long had a Federal Reserve System that sets short-term interest rates; true, the institutions that have been nationalized have always been Government-Sponsored Enterprises (GSEs), privately owned but with a government mission and implicit guarantees to lenders; true, too, the government has long insured depositors at savings institutions against loss. But never before has the government so massively and systematically socialized the risks undertaken by the one-time masters of the universe, Wall Street’s investment bankers, who until now more or less controlled the allocation of capital among its several capitalist claimants. Now, the last pure investment banks—Goldman Sachs and Morgan Stanley—have surrendered substantial freedoms by opting to become deposit-taking institutions, subject to federal regulation, in return for access to support of the Fed in times of need. It is not much of an exaggeration to say that capitalism as we
have known it is no more, and that a New Capitalism is once again in the process of creation.

A revolution has succeeded when the opponents of change capitulate. Which is what has happened in America in the past several months: a conservative Republican President, a conservative central banker, and the former head of the most successful investment bank in the world combined to agree with capitalism’s left-leaning critics that fundamental change is required. Game, set and match to the revolutionaries. If you doubt that, consider only the change in the position of the President and his Treasury Secretary, who have gone from seeking the demise of Freddie Mac and Fannie Mae to preserving their role in extending home ownership to the socially optimum level. And if you want more proof of the capitulation of the free market set, note that Alan Greenspan, a devoted disciple of Ayn Rand, hardly shrugged when he called for the establishment of a panel of financial wise men to tell the government which troubled financial institutions are worthy of government-funded bailouts, and which should be allowed to pass from the scene. This is not market capitalism, “red in tooth and claw,” as we once knew it.

The features of this New Capitalism are:

• a reduction of the willingness of individuals and politicians to accept the risks inherent in the market system as it has been structured and as it has functioned until now

• a turn away from the bias in favor of deregulation that saw airlines, trucking, banking, electricity generation, natural gas production and other industries freed from pervasive (although not all) government control

• a refusal to continue accepting without question the market’s verdict on how income and the fruits of economic growth should be distributed

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• the rejection of the idea that the benefits of free trade are so obvious, and so widely distributed, that the post-World War II free-trading regime should be extended, and

• insistence that the balance between considerations of economic efficiency and equity that has guided public policy since the end of World War II be changed in favor of equity.

This is not the first time in recent history that we have seen the supporters of capitalism capitulate to those who would revolutionize it, not by tinkering at the edges, but by changing the basic assumptions on which it operated. In the Great Depression Franklin Roosevelt and his aptly named Brain Trust decided that securities markets could no longer be allowed to operate on a caveat emptor basis and created the Securities and Exchange Commission to inject transparency and a modicum of control over the worst practices of Wall Street’s securities peddlers. The New Dealers also decided that the banking system could no longer be allowed to operate on a basis that exposed depositors to the risk of losing their lifetime savings; enter the Federal Deposit Insurance Corporation and insurance for depositors. And because they believed that the social advantages of homeownership, an “externality” not reflected in mortgage rates and house prices, demanded the creation of a government-sponsored enterprise, the Democrats gave us Fannie Mae and the implicit guarantee of its IOUs, bringing mortgage rates down and homeownership up.

When Ronald Reagan accepted the advice of Irving Kristol and other thinkers writing in the Public Interest magazine that conservatives would do well to accept much of the New Deal and move on, the New Deal revolution was complete and irreversible. For better or worse, the Roosevelt revolution became part of America’s economic architecture.

The capitulation of opponents to reform has had a similar effect in Great Britain. Margaret Thatcher ended conservatives’ opposition to the National Health Service, and state provision of health care became
an uncontestable feature of British life. Tony Blair succeeded her, and instead of seeking to roll back her reform of the structure of the British economy accepted, on behalf of the Left—and a very far Left it was and is, by American standards—her privatization of most of the enterprises that Labour had taken into state ownership when it decided to control “the commanding heights of the economy.” He also removed from the Labour Party’s constitution its famous and much-beloved-by-the-faithful Clause 4, promising nationalization of Britain’s important industries. Thus, while Thatcher made socialized medicine permanent by capitulating to the Left, Blair made the restoration of a vigorous private sector permanent by capitulating to the Thatcherite Right’s privatization measures and its reining in of trade union power.

It is just such a Thatcher-like capitulation to the Left that we have are witnessing in America, and will continue to witness as we move from the capitalism we have known since Franklin Roosevelt recreated it in his own image, to a New Capitalism.

**We may not be the nation of whiners that Phil Gramm believes we have become, but neither are we as tolerant of risk as we once were.**

“Capitalism without failure is like religion without sin,” notes Allan Meltzer, one of the nation’s most astute economists. Perhaps. But the New Capitalism has little room for the pain associated with failure. In the case of individuals, policies are being crafted to make it easier for people delinquent on their mortgage payments to stay in their homes—to be absolved of sin only to sin again, as the Old Capitalists would have it as they mourn the lost era of individual
responsibility. Mourn, yes, but also acquiesce, however grudgingly. There is no constituency for going back to the harsher regime of the Old Capitalism, which countenanced an occasional amelioration of economic pain for enterprises in difficulty—the Chrysler bailout of 1980 and the airline bailout after 9/11 leap to mind—but not a systematic reduction of the consequences of poor management, bad judgment, or just plain bad luck.

A major feature of the recent revolution is New Capitalism’s attitude towards the risks of recession and of systemic failure. At the very first hint of a slowdown, Federal Reserve Board Chairman Ben Bernanke, a conservative scholar, eased monetary policy. No waiting around to determine whether a major downturn was brewing, or for growth to turn negative. No willingness to risk the sort of mild recession that has characterized the post-World War II period; a risk appeared, and the Fed felt it necessary to lower interest rates. Never mind that such a move would drive down the dollar, and therefore drive up oil prices as producers raised prices to offset the lower value of the dollars in which they are paid. Under the Old Capitalism, the authorities in charge of monetary and fiscal policy quite correctly assumed that the public generally understood that the business cycle had not been outlawed, and was willing to bear the moderately bad times that often followed the very good ones. But the assumptions of the Old Capitalism are gone, overwhelmed by the assumptions of the New concerning the tolerable level of pain and risk. The old order capitulated: the central bankers who are supposed to ensure that our currency holds its value, and at one time did just that, subordinated that goal to the avoidance of pain from a bursting bubble. That they might have made the right decision, given the balance of risks between inflation and recession, is less relevant than the fact that the balance they struck is probably different from the one that most Old Capitalism central bankers would have deemed correct.

That is only one way in which capitalism as we once knew it has been superseded by a new variant. We may not be the nation of whiners that Phil Gramm believes we have become, but neither
are we as tolerant of risk as we once were, and that not so long ago.

Nor are the New Capitalists willing to tolerate the risk of systemic upheaval. In the days of Old Capitalism we always guessed that there were some banks that were simply too big to be allowed to fail, and we were willing to live with the moral hazard—inducement to bad behavior—that such a quasi-guarantee inevitably entailed. Yes, we did put in place regulations that gave the government authority to look into the affairs of banks whose deposits it was insuring. But the basic thrust of policy was to allow financial institutions to ride the deregulation wave that affected so many industries. Banks’ activities had been limited by the Glass-Steagall Act of 1933, but with its repeal in 1999, a deregulatory step that President Clinton supported enthusiastically at the time and has continued to defend as recently as September 2008, banks were freed to expand into new business lines, even though this increased the risk of bank failure. And if they failed, they failed; depositors were protected. As for those with funds at uninsured investment banks, the stock exchanges developed various protections, among them the Securities Investor Protection Corporation (SIPC). No government intervention necessary.

That was then, and this is now. President Bush, a defender of free-market capitalism, Secretary of the Treasury Hank Paulson, and Fed Chair Ben Bernanke all agreed that some financial institutions are too interconnected to fail—not too big (size is easily quantified), but too interconnected (measure that if you dare). Let Bear Stearns go under, these conservatives concluded, and all of the companies with which they do business (the counterparties) might be brought down with them. Failures of this sort might be tolerable under the Old Capitalism, with affected firms left to sort things out. But not under the New. Too risky.

So the government—a Republican government—organized a bailout to avoid a bankruptcy, using taxpayer funds to prevent creditors of Bear Stearns from losing money, protecting counterparties who should have been able to appraise the fitness of the firm with which
they were dealing, and saving shareholders from a complete wipeout, a process repeated when highly “interconnected” insurer AIG faced collapse. True, fearful of seeming to pay no heed at all to the risk of moral hazard, Paulson & Co. did let Lehman Brothers fail, but only after making certain that the Fed stood ready to mitigate collateral damage by taking on the paper of affected firms—and, after contemplating with horror the consequences of that decision, moved massively to counteract it by attempting a massive bailout of the entire banking system.

So we have a conservative appointee of a conservative president fighting—successfully as it turns out—to persuade Congress to allow the administration to take billions in bad loans off the hands of the institutions that made them, and put them on the books of the federal government. The risk associated with these bits of dicey paper is not reduced, of course; it is merely transferred from the shareholders and creditors of the banks to the taxpayers.

This socialization of risk troubles left-leaning politicians not at all—indeed, they are in the business of reducing the role of individual responsibility as a constraint on behavior, and turning management of risk over to an increasingly powerful government, endowed with a panoply of new regulatory tools. Which are now an inevitable feature of the New Capitalism, not only accepted, but in part created by the very people who once fought government intrusion bitterly.

Future students, struggling to understand the New Capitalism, may well be puzzled by one feature: the absence of a dominant, cohesive, ideology-driven class. J.P. Morgan, with his well-tended paunch, bedecked with the gold watch chain that was the decoration of choice of his class, the fellow-bankers whom he summoned to his mansion to manage the economy lest the government put its hand to that chore, constituted easily identified members of the Old Capitalist class. New Capitalists Hank Paulson and Barney Frank, by contrast, are rather ordinary-looking sorts, brought together by pragmatism rather than ideology. One can picture Morgan and his colleagues attending the same balls, Dick Cheney and Don Rumsfeld hunting together, or Bill
Gates and Warren Buffett comparing notes about philanthropy over Diet Cokes. These are Old Capitalists, with common political and economic interests, and socially compatible. Try, now, to picture Barney Frank joining Hank Paulson on a bird-watching trip, or Bob Rubin mountain-biking with George W. Bush. Can’t. The New Capitalism is distinguished by the lack of anything that might be called a “class.” It is, rather, a marriage of otherwise very different people who have come to agree that market capitalism, that cauldron of creative destruction, must henceforth be less destructive, even if that means it will also be less creative.

This absence of a definable class is only one distinguishing feature of the New Capitalism: another is the presence of rampant moral hazard—the increase in the incentive to repeat bad behavior created by past failures to punish such behavior—and the consequent need for pervasive regulation. It is obvious that any economic player who knows that the government will bear the losses resulting from his risky behavior will be tempted to take chances he would otherwise avoid. Run into trouble because you have lent imprudently, and you can take the bad IOUs to the Fed; create instruments that involve so much leverage that your balance sheet is impaired, and the government will relieve you of some of the debt or, perhaps, pump equity capital into your enterprise. The effect of the government’s reduced willingness to tolerate threats to the financial system is to socialize losses while profits remain privatized, a point grudgingly recognized by the former opponents of government intervention who are now rushing to create the regulatory structure of the New Capitalism.
The latest radical change in capitalism—every bit as radical as the New Deal, Thatcher’s Tory fundamentalism, and Blair’s New Labour—has swarms of Federal Reserve System regulators descending on the banks to make sure that the availability of bailouts does not prompt them to take on too much risk, or too much debt. It has the Securities and Exchange Commission declaring certain securities off-limits to short sellers, once revered by defenders of free markets as contributing to liquidity and stability. It has state regulators attempting to arrange mergers of insurance companies lest coverage for certain financial risks become unavailable. It has Paulson consorting with liberal Democrat Barney Frank to create a truly pervasive scheme for the regulation of mortgage markets, now that the government has made explicit the previously implicit guarantee of the debt of its two GSEs, Fannie Mae and Freddie Mac, and has acquired the power to pump equity capital into those enterprises should it prove necessary. It has the Fed regulating the activity of mortgage brokers. It has the Treasury reviewing the compensation of bank presidents. And it has the Fed and the SEC quarreling over which organization will get the additional staff and funds to oversee activities of the new beneficiaries of government largesse.

There’s more, but you get the idea. Under the New Capitalist regime, Wall Street is a subsidiary of Pennsylvania Avenue and Capitol Hill. Banking’s lambs lie down with the bureaucracy’s lions, and it is now only a question whether they will be devoured, or pull off one of the great regulatory captures—co-opt the regulators—of the twenty-first century.

Old Capitalism might be a thing of the past, but a hearty band of Old Capitalists has not yet run up the white flag. This ragged band gathers under the banner of fighting inflation, which involves allowing even important financial institutions to fail rather than bail them out by issuing currency with which to buy their dicey IOUs. It has important, well-respected members, but since the defection of many of its members to the ranks of those fearful of systemic failure, they are outnumbered and leaderless.
If a heightened aversion to failure, with its curative powers, were the only feature of the New Capitalism, the new regime might be of direct interest only to the firms affected by the death of the old regime, and the politicians and regulators who are busily crafting changes to the Old Capitalist system. But there is more, much more to the new system.

This is not the place to wade through the competing data on the distribution of income and wealth in the United States. To those who contend that a tiny percent of the population—the richest of the rich—are claiming all of the benefits of recent economic growth, while the middle and poorer classes are falling further and further behind, defenders of what has become the Old Capitalism respond that the rising tide of the past decades has lifted all boats, some more than others, but all boats.

In this debate the welter of income distribution data is somehow irrelevant. Something fundamental has happened that is affecting incomes and their distribution in ways that are both irreversible and, in the end, unacceptable.

More than one billion relatively low-paid workers have entered the international labor market in a process that has come to be called globalization. These workers, whose living standards and wage requirements have only now begun to inch up from subsistence lev-
els, compete directly with low-skilled American (and other developed countries’) workers who produce T-shirts and sneakers, and with some higher-skilled workers who produce everything from automobiles to electronic goods. This new competition places downward pressure on wage rates—just how much is not really important—in developed countries, and threatens the jobs of workers who have done nothing wrong except to be in the wrong workplace at the wrong time in the economic history of the world.

Meanwhile, the very same globalization that is sapping the bargaining power and the real incomes of some workers, is increasing the value of many in the managerial class. A Goldman Sachs dealmaker can make millions arranging mergers between his U.S. clients; he can make hundreds of millions arranging deals across national boundaries. A CEO of a local or even national brewery can make a fine living supervising his regional or national distributors and brew masters; a CEO of an international brewery can spread his talents over millions more in assets and thousands more employees, and demand to be compensated accordingly.

These forces alone explain the emergence of a dissatisfied, hard-put-upon working class and an increasingly affluent managerial and entrepreneurial class in America. No matter that these same forces are raising more people out of poverty, more quickly, than at any time in recorded history. That should be unambiguously good news, but regrettably it is not, at least not to workers in the developed economies. As the Chinese masses get richer, as the Indian masses learn the skills that are enabling them to thrive in a high-tech world, they, too, want decent food, and cars instead of bicycles. Add this new demand for food and fuel to existing demand, and prices will rise, to the consternation of consumers in already-wealthy countries who under the Old Capitalism faced no such competition for resources. And because the response of supply to such demand pressures is far from instantaneous (especially in oil markets dominated by an international cartel, and food markets dominated by politically powerful farmers who demand and get artificial price supports), prices rise more than a little.
Throw the relatively stagnant incomes of many workers into the mix, and unhappiness with the way markets are working in the new, globalized world mounts, putting pressure on Old Capitalism’s way of life.

That pressure is increased by tales of excessive executive compensation. Few begrudge Warren Buffett his billions, earned by shrewd investing. Or Bill Gates his billions, earned by creating a great company that has changed the way the world does business, consumers shop, and children play. Few even begrudge risk-taking entrepreneurs their billions, at least those who risk penury and do not benefit from strange quirks in the income tax system such as those that have enriched some private equity entrepreneurs.

The New Capitalism includes more direct controls on incomes than the Old Capitalism could even imagine…. As a result, government is undertaking previously unheard-of intrusions into the paneled board-rooms of corporate America.

But when CEOs manage to wreck the companies over which they preside, and drive down the value of the enterprises they manage, and nevertheless stroll into the sunset and onto golf courses with hundreds of millions in bonuses from board members grateful for past favors (and perhaps hoping for similar treatment some day), Old Capitalism becomes increasingly difficult to defend. Never mind that the recent failure of the rising tide to raise the boats of everyday workers might be due to a temporary and unsustainable increase in
the premium on skills and education. Somehow, a tide that fails to raise workers’ rowboats, but seems to lift the yachts on which failed CEOs cruise into the future, offends voters’ sense of fairness. The result is that the entire system of income distribution loses its popular support—or at least enough of that support to justify government policies to reorder the distribution of incomes.

That is why Democratic attempts to restore the progressivity of the pre-Bush tax cuts are likely to succeed, as the New Capitalists recast the tax structure erected in the waning days of the Old Capitalism. This is one area in which the Old Capitalists have not capitulated, and are mounting a last-ditch effort to preserve the after-tax income distribution system produced by the Bush tax cuts. They will lose, whether to a President Obama, or to a Democratic Congress that will drive an only apparently reluctant President McCain back to the position that he took when first confronted with the tilt of the Bush cuts—they just don’t seem fair.

And it is why the New Capitalism includes more direct controls on incomes than the Old Capitalism could even imagine. The massive (and in many cases well-earned) incomes of hedge-fund operators and private equity entrepreneurs, and the (in some cases well-earned) substantial bonuses of corporate executives, have combined with ostentatious displays of wealth to add fuel to simmering egalitarian fires. Toss the gasoline of golden goodbyes that seem to reward failure onto those fires, and complaints about “fat cats” become conflations in places where this form of class warfare until recently received little attention. Now, we have candidates of both parties competing to see which can denounce “greed” with greater frequency and ferocity.

Government is undertaking previously unheard-of intrusions into the paneled boardrooms of corporate America. Board members, especially those serving on compensation committees, can no longer be friends of or dependent on the good will of the executives whose salaries they set; they must be independent. And “independent” as judged by tests set by regulators. Auditors cannot build life-long, cozy
relationships with the executives and directors whose bookkeeping they are charged with reviewing; they must make way for other independent auditors after a number of years. Executives are now required by law to attest to the accuracy of the financial statements on which they ask the public to judge their performance. And executive compensation must be related somehow to performance, and be transparent.

There is a risk in all of this, of course. As the great F. A. Hayek pointed out in his classic, *The Constitution of Liberty*:

> It is questionable whether a society which will recognize no reward other than what appears to its majority as an appropriate income, and which does not regard the acquisition of a fortune in a relatively short time as a legitimate form of remuneration for certain kinds of activities, can in the long run preserve a system of private enterprise.

He is right, of course, at least in part. No such society can preserve its existing system of private enterprise, what I have been calling the Old Capitalism. But it can preserve a modified private enterprise system, a New Capitalism, one that accepts the legitimacy of even the highest incomes because it is satisfied that the method by which those incomes are earned is reasonable and fair—two rather vague but nevertheless meaningful concepts. To paraphrase Justice Potter Stewart’s comments about pornography, we might not be able to define fairness, but we know unfairness when we see it.

Less obviously, rising discomfort with the income distribution system has led New Capitalists to seem to reject the notion that free trade is an unambiguously good thing. Whatever else free trade has done—and it has done a great deal to enrich the macroeconomies of those nations that have opened their economies—it has not shared its benefits in socially acceptable ways. It has enabled globalization to enrich managers and entrepreneurs, quite often properly, without
conferring similar (or in some cases, any) benefits on other hard- 
working men and women, for reasons laid out above.

Adam Smith teaches us the virtues of the international division of 
labor that free trade makes possible:

To give the monopoly of the home-market to the 
produce of domestic industry … is in some measure 
to direct private people in what manner they ought 
to employ their capitals, and must, in almost all 
cases, be either a useless or a hurtful regulation…. If 
a foreign country can supply us with a commodity 
cheaper than we ourselves can make it, better buy it 
of them with some part of the produce of our own 
industry, employed in a way in which we have some 
advantage. (Wealth of Nations, IV.ii.182-3)

Smith’s statement provides only a starting point for the formulation 
of trade policy in the New Capitalism. Free trade maximizes econom- 
ic efficiency (I ignore here some important caveats), a subject to 
which I shall return when I discuss the relative roles of efficiency and 
equity in policymaking. But free trade creates losers as well as win- 
ers. In addition to the aforementioned executives of increasingly 
international companies, the winners are consumers, as any stroll 
down the aisles of Wal-Mart will make clear. The losers are some 
producers—those who have invested capital in companies that can- 
not compete with overseas suppliers—and some workers—the ones 
employed by those companies. Not all of these workers are members 
of trade unions that have a history of exploiting monopsony power, 
as was the case in the auto and steel industries, in the days when 
domestic manufacturers, not faced with effective competition from 
imports, could pass on to captive consumers cost increases created by 
unions with a monopoly of the available labor supply. It is difficult to 
shed many tears for these Old Capitalism exploiters of consumers.

But many workers hurt by imports have played the game the way
we have asked them to—worked hard, devoted decades to their employers, and paid their taxes. Suddenly, the world changes, and through no fault of their own these workers find themselves unable to compete with labor in countries where labor is abundant and cheap. Nothing in economic theory teaches that policymakers should care less about workers than about the consumers who benefit from low-cost T-shirts, sneakers, and television sets, especially in an era in which currency manipulation is rife, and barriers to the sale of America’s important exports—the three “A”s of aircraft, agriculture, and audio-visual products—are quite high.

In the New Capitalism, high incomes are unacceptable if they do not bear a reasonable relationship to the value produced.

What economics can teach is that attempts to prevent the adaptation of the economy to the new circumstances of global trade will either be costly or futile. America has always been characterized by massive job destruction and even more massive job creation, as resources move from where they are no longer needed (or are less needed) to where they are most needed. This fluidity keeps an economy growing. Which is more or less where Old Capitalism left the matter, aside from a few tiny and futile efforts to ease the plight of the adversely affected by concocting a variety of under-funded programs administered by often-competing agencies. Enter the New Capitalism, and a groping for policies to transfer some of the gains of the winners to the losers (John McCain’s federally funded retraining programs), or to limit the extent of the pain inflicted on losers by instituting de facto protectionist measures (Barack Obama’s insis-
tence on standards that raise the labor costs of our trading partners). Both attempts to offset the imbalance caused by the trade regime of the Old Capitalism are defended as necessary to reduce the opposition to change resulting from technological advances, new trade patterns, and globalization.

Call those measures what you will—reductions of the efficiency gains associated with trade, or a necessary offset to the imperfections of the international trading regime, or the moral obligation of winners to share their gains with the losers—they are one manifestation of New Capitalism’s rejection of the distributional results of the Old.

In the New Capitalism, high incomes are not unacceptable merely because they are high; they are unacceptable if they do not bear a reasonable relationship to the value produced by their recipients. That is nothing more than a shorthand statement of the economists’ more precise (and therefore less understandable) notion that in a properly functioning market-economy, incomes are related to the marginal revenue product—broadly, the value—of the output of workers at all levels. Corporate boards distort income distribution by refusing to relate compensation to performance; trade unions distort income distribution by claiming more for their members than they would earn in a competitive labor market; nations that artificially depress the value of their currencies in order to win overseas markets reduce the earnings of workers in other countries below what they would be in free markets. All of these distortions divorce effort and success from compensation. Where pay and performance are clearly related, there is little criticism of high incomes. In the world of sports the boos are reserved only for those who fail to deliver what fans believe are batting and earned-run averages commensurate with salaries.

New Capitalism’s bureaucratic and regulatory classes are less concerned with the distorting effect of trade-union activities, of course. But the emergence of competition from firms in non-union jurisdictions and in low-wage nations limits the ability of the unions to maintain these extra-market wages without serious job losses, a sort of self-correcting process, as workers in the auto industry have discovered.
No such automatic adjustment is possible when it comes to trade. Our trading partners can maintain the downward pressure on American wages by pegging their currencies to the dollar, denying us the advantages of a softening currency—only one of the so-called “unfair trading practices” deployed by foreign countries. New Capitalism’s ruling class intends to do something about that, regardless of the effect on the boom in exports that has helped keep the current slowdown from lapsing into a major recession.

The New Capitalists also intend to call upon an old-fashioned constraint to rein in executive compensation: shame. The drive to make compensation transparent relies for its effectiveness not only on the notion that shareholders might intervene in the most egregious cases, but also on the idea that many executives will find a listing of their various perks—down to club membership and free floral arrangements daily—a tad embarrassing. Yes, we economists know that removal of such perks might result in higher pay, but somehow that is considered less “shameful” than an already highly compensated movie star demanding—and getting—as part of his or her compensation daily delivery of M&Ms of a specified color.

An important feature of the New Capitalism is the elevation of equity to a role co-equal with efficiency, or perhaps even superior to it, as a guide to policy. It might maximize efficiency for government to minimize its interference in economic affairs, which is the position of defenders of Old Capitalism—proponents of deregulation, of low taxes on the most highly productive members of society, and of non-interference with the results of the American meritocracy. And efficiency, in the form of rising productivity, is the driving force behind increasing material well-being. Unassailable.

But man does not live by efficiency alone, at least not New Capitalist man. There is something offensive to the public sensibility about the multi-million-dollar birthday parties that some hedge fund operators favor in an era in which middle-income families are struggling. This is not to deny that those middle-class struggles are often
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self-imposed by people who refuse to make trade-offs, and find that it takes two jobs to support the living standard that their emulation of their peers has caused them to adopt. Or that the string of “entitlements” has been expanded to include items not considered essential by their parents. For whatever reason—good or bad—we are about to see equity elevated over efficiency as New Capitalists recast the tax structure erected in the last days of Old Capitalism.

None of this is to say that the New Capitalism will produce material results superior to the Old Capitalism, which has been no slouch at improving living standards and eliminating poverty. Or that its new regulations, new trade regime, new tax structure, or new emphasis on fairness will satisfy those who are driving these changes. I have my doubts on both scores. The New Capitalists have not entirely met the burden of proof that rests on those who would change a system that has done so much to improve the lot of those fortunate to live under it. But they have the bit in their teeth and little opposition, now that conservatives have capitulated.

There can be no doubt that the world has changed, that capitalism as we knew it even until a few years ago is no more, and that we who remain saddened at some of the changes had better learn how to make the New Capitalism function as well as it can, and how to head off additional, more draconian interventions in markets, rather than confine ourselves to cursing those who have capitulated to the reshaping of capitalism in ways that worry us.
Perhaps the most important contribution would be the development of new regulatory tools. As things now stand, the drift is towards supervisory regulation—more inspectors, more bureaucratic determination of such things as appropriate levels of leverage and risk-taking, more intervention in a host of decisions that regulators are ill-equipped to make. Those who favor free markets, but recognize that we are entering a New Capitalism age, must attempt to divert the demand for such regulation into a recognition that it would be far more efficient to devise rules that get the incentives right.

Mortgage brokers can be made to continue to bear some of the risk associated with the mortgages they write; the fee incomes of rating agencies can be made independent of the frequency of the number of triple-A ratings they issue; the incomes of bankers can be made to reflect both big wins and big losses, over a reasonable period of time. With the right incentives in place, it is more likely—not certain, but more likely—that the only slightly less invisible hand will lead all of the players in financial markets to promote society’s interest in a less catastrophe-prone financial system.

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