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Capitalism Reassessed

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— ✤ CHAPTER EIGHT ✤ —

How Capitalism Will Change

Niels Bohr, the brilliant Nobel laureate in physics, once complained, "It is difficult to make predictions, especially about the future." Despite his warning, let's try. Even if we cannot know exactly how capitalism will change, we can, perhaps, detect some probable trends and directions.

Our first task is to survey some of the major forces that could lead to important institutional transformations. We then ask what types of general systemic change might result from such institutional transformations. Finally, we turn to existing capitalist systems and speculate briefly but with more specificity on how they might change in the next half-century.

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A. Short-Run Factors Possibly Influencing Major Institutional and Systemic Change

Traumatic political/economic events are often a cause of major institutional change. For instance, Russia's defeat in the Crimean War (1854–56) set in motion forces that resulted in the abolition of serfdom five years later. The Great Depression of the 1930s led to greater state intervention into the economies of the OECD nations and much higher welfare transfers to the population. Less dramatically, British discontent with slow, uneven production growth in the post–World War II years appears to have played a major role in Margaret Thatcher's 1979 political victory and to have allowed her to make changes in the economic system, particularly the dismantling of governmental controls and detailed planning of the economy.

Will a transformation on the scale of what happened in the United Kingdom in the late 1970s again occur in the OECD nations as a result of the world economic crisis that took place at the end of the first decade of the twenty-first century? To provide some perspective on this question, Table 8–1 presents data on growth and fluctuations of aggregate production from 1975 through 2007 that supplements the data presented in Table 6–3.[1] While

[1] The data in Table 6–3 are, however, organized according to performance system, rather than economic system. That table also looks

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Table 8–1. ***GDP Growth and Fluctuations in Industrial Capitalist Nations, 1975–2007***[a]

Country	Average Annual GDP Growth	Fluctuation Measure	Country	Average Annual GDP Growth	Fluctuation Measure
A. Countries with a *mostly Anglo-Saxon* economic system			B. Countries with a *Nordic* economic system		
Australia	3.22%	2.35%	Denmark	2.14%	2.09%
Canada	2.78	2.84	Finland	2.50	5.19
Ireland	5.20	9.78	Norway	3.06	2.47
Japan	2.53	6.72	Sweden	2.07	3.54
New Zealand	2.25	5.33			
Switzerland?	1.64	2.20			
UK	2.42	3.85			
USA	3.06	2.12			
Average	2.89	4.27	Average	2.44	3.22
C. Nations with a *West European* economic system			D. Nations with a *South European* economic system		
Austria	2.35%	1.70%	Greece	2.05%	6.56%
Belgium	2.12	1.57	Italy	2.02	3.50
France	2.16	1.80	Portugal	2.94	4.38
Germany	2.13	3.13	Spain	2.82	3.87
Netherlands	2.58	3.03			
Average	2.27	2.25	Average	2.46	4.58

[a] The fluctuation measure is the average square of the deviation of each point from the ordinary least squares regression line used to determine the average annual GDP growth rate. It is also called the "mean square error." The GDP data come from the World Bank's *World Development Indicators* www.worldbank.org.

economic growth was certainly not dramatic in this period, which preceded the major economic crisis starting in 2007/2008, voters in the various countries did not appear to be sufficiently discontented with the economic system to force major changes, at least not at the time of writing. Equally important, none of the four capitalist economic systems in this period appears markedly superior in its macroeconomic performance. More specifically, the initial level of per capita GDP and the exposure to the outside world (measured in terms of the ratio of exports and imports to the GDP) are held constant, only the *mostly Anglo-Saxon* economic system had slightly (but statistically significant) higher growth rates than nations with the other systems; and only the nations with a *West European* economic system had a slightly lower (but statistically significant) rate of fluctuation of the GDP.[2]

at growth of per capita GDP, while Table 8–1 focuses just on GDP growth.

[2] This calculation is similar to that shown in Table 6–3 but differs in that other possible causes of macroeconomic performance are held constant (namely, initial per capita GDP and openness of the economy). I also experimented with two other measures of fluctuations, the coefficient of determination of the GDP regressions and the average unemployment rate over the period. When other factors were held constant, neither of these two indicators revealed any statistically significant difference between the four economic systems.

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In the recent global recession, measured from the 3d quarter of 2007 to the 3d quarter of 2009, the average annual decline in real GDP was 1.7 percent.[3] This decline, however, varied considerably among the OECD countries, with the countries with a Nordic economic system experiencing the greatest average fall in GDP; and the countries with a West European system, the least. Nevertheless, these differences were not statistically significant.

Such results, combined with those in Table 6–3, mean that no particular type of capitalism provided a clear model of emulation for the others, at least with regard to GDP growth.[4] Instead, the governments' policies and

[3] The data in this paragraph come from the OECD Web site www.OECD.org and were the last available at the time of writing.

[4] Of course, this doesn't necessarily mean that a greatly different economic system, such as central planning, would provide better results. For a comparison between economic performance of capitalist and centrally planned economies, see Frederic L. Pryor, *Economic Systems of Foraging, Agricultural, and Industrial Societies* (New York: Cambridge University Press, 2005). *op. cit.*; "Growth and Fluctuations of Production in OECD and East European Nations," *World Politics* 37, no. 2 (January 1985): 204–38; and "The Performance of Agricultural Production In Marxist and Non-Marxist Nations," *Comparative Economic Studies* 33, no. 3/1991: 95–127. These studies show that the centrally planned nations of Eastern Europe and the OECD nations of Western Europe did not have significantly different GDP growth rates and GDP fluctuations. For individual sectors, such as agriculture, the evidence is mixed and depends on the time period and the measure of fluctuations.

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factors other than the economic system seemed to be the primary explanation for these different growth results. Consequently, unless the downturn in production in the industrial capitalist nations becomes considerably worse and lasts much longer lasting than it appeared in 2010, it seem unlikely that major systemic transformations will occur for two reasons: First of all, radical alternatives to capitalism, such as communist command systems, have been discredited; secondly, systemic inertia is formidable, as was shown in the Great Depression during the 1930s, when few countries adopted total different economic systems.

B. Long-Term Economic Trends Possibly Influencing Institutional Change

This section briefly outlines some challenging worldwide trends that are not easily met by existing institutions or current economic policies and that point to important institutional changes in the long-term future.

1. Demographic Changes

As everyone knows, the average age of the population in the OECD is rising. This will lead to a fall in the ratio of people in the traditional working ages (twenty through sixty-four) to people aged sixty-five and above.

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For the OECD nations considered in this study, this ratio of working age to aged in 2000 averaged about 3.93; by 2040, it will be roughly 1.92.[5] In the latter year the ratio is predicted to be highest in nations with the *mostly Anglo-Saxon* and the *Nordic* economic systems and lowest in nations with the *West European* and *South European* economic systems, where predicted low birth rates will exacerbate the problem.

Obviously, the aging of the population will strain governmental pension and health care payments and old-age insurance. If current laws remain in force in the OECD, governmental expenditures for the aged as a ratio of the GDP are predicted to rise about twelve percentage points between 2000 and 2040, an increase which may be unsustainable.

2. Globalization

The word "globalization" has many meanings – political, legal, cultural, and economic. It also means that local events – phenomena as diverse as the incidence of disease and stock-market crashes – can have worldwide effects. The process of globalization also has many institutional impacts. For instance, enterprise governance,

[5] The data in this and the following paragraph come from Frederic L. Pryor, *Economic Systems of Foraging, Agricultural, and Industrial Societies*, *op. cit.*, Chapter 7.

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which varies considerably between nations, even those with the same economic system, appears to be gradually converging, at least if we can believe the anecdotes in the business press. In this section, however, we focus only on several common indicators of globalization (foreign trade, market integration, immigration, and international flows of capital) to gain an overview of some quantitative measures of the process.

Foreign trade, as a share of total production of goods and services, rose almost twenty percentage points between 1952 and 2000 for the twenty-one OECD nations under consideration.[6] Market integration – the linking of markets for goods and services – is measured by price convergence in the OECD countries, and this gradually occurred, at least in the latter part of this period. Immigration rates rose dramatically in the last half of the twentieth century. More specifically, for the twenty-one OECD nations, the annual ratio of new immigrants to the total population rose from 0.2 to 0.8 percent between 1984 and 2000 (if illegal immigrants had been included, the increase would undoubtedly be higher). International capital (investment) flows have also soared: in the quarter century between 1972 and

[6] Data for the discussion in this paragraph come from the OECD and Frederic L. Pryor, *The Future of U.S. Capitalism* (New York: Cambridge University Press, 2002), Chapter 5.

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1997, estimated world capital flows measured in constant prices, both direct (plant, equipment, and housing) and indirect (stocks and bonds) increased at an average annual rate of 8.3 percent, more than twice as fast as the growth of world GDP.

In the recession years between the third quarters of 2007 and 2009, the average annual decline in the dollar value of exports of the OECD countries of goods was 6.6 percent.[7] As in the case of the GDP, however, there was no significant difference in the countries with different economic systems.

Globalization also means that adverse economic shocks arising from the actions of other countries will have a greater impact on the domestic economy of each nation.[8] It will take years to strengthen institutions so as

[7] These data come from the OECD Web site www.OECD.com and were the latest available at the time of writing.

[8] One example of the international transmission of a local crisis: early in the twenty-first century a group of Wisconsin school boards borrowed money at a low interest rate from an Irish bank to purchase collateralized debt obligations (CDO) yielding a higher return. In 2008, when some of the underlying securities of the CDOs collapsed in value and the CDO issuers were unable to make their payments to the school districts, the latter could not then meet their interest payments on the loan from the Irish bank. This, in turn, placed the Irish bank in financial jeopardy, and, since it was owned by a German bank, the parent bank also found itself in a precarious financial position and had to be bailed out by the

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to regulate international economic activities and prevent or mitigate worldwide shocks; meanwhile, we must rely on the informal coordination of policy actions in many countries, such as the G-20 group. In isolation, domestic actions to counter adverse macroeconomic events will become less effective. In a recession, for instance, the purchasing power arising from the increased governmental expenditures of a single nation will be partially spent abroad, so that fiscal policy becomes less effective. Other important implications of the globalization process, including income convergence or divergence between countries, must be left for others to discuss.

3. Increasing Scarcity of Natural Resources[9]

The world's total use of raw materials and foodstuffs has risen steeply in the past century because of the swelling population and increasing per capita production. Although global population growth has been slowing in the past few decades, the consumption of these basic products will undoubtedly continue to grow as per capita income increases and, other things being equal, will result

German government. There was no easy policy action that the German government could on its own have taken to have prevented this international transmission of a financial crisis.

[9] This discussion draws heavily upon the sources and analysis in Pryor, *The Future of U.S. Capitalism*, *op. cit.*, Chapter 6.

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in supplies become increasingly strained. Nevertheless, this Malthusian nightmare of critical scarcities of foodstuffs and raw material and of their skyrocketing prices, did not come true in the twentieth century. It was kept at bay by technological progress in extracting, growing, refining, and processing these products, by the discovery of new mineral deposits, by the use of new land for agriculture, and by the production of new products that required fewer raw materials.

Unfortunately, it is unclear whether technology will continue to win the race with scarcity. In the first decade of the twenty-first century, the prices of many raw materials have risen much faster than the general price index. Moreover, as the long-term price of oil has climbed, the costs of some nonpetroleum sources of energy have increased as well. Given the stationary or declining oil production in most major oil-producing nations and the relatively few new discoveries of large oil deposits, it seems likely the long-term rising price of energy will continue until alternative energy sources become much more fully utilized.

Rising food prices seem likely as well: between 2000 and 2007 world food prices rose 80 percent, and many fear even steeper increases in the future. Probable underlying causes include global warming, water shortages, and the diversion of grains from food to the production

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of ethanol, which has, in turn, led to a reduction in the land used for other crops and feed for animals.[10]

If the relative prices of raw materials, energy, and foodstuffs rise, the low-income population will be the hardest hit, since raw-material intensive products and foods will cost more and thus constitute a higher share of the spending of this group. Thus, the distribution of real income will become more unequal. Moreover, the higher price of raw materials also means that for a given expenditure, fewer goods can be purchased, and for a given dollar of investment, less growth of goods and services will result.

4. Other Challenges

a. Savings and Growth. Where population is rising and where people spend down their wealth during retirement, the overall savings rate should decline under normal circumstances. as the number of workers per retirees declines. More specifically, empirical studies

[10] The datum on world food prices comes from Food and Agriculture Organization, "FAO Food Price Index," www.fao.org/worldfood-situation/FoodPriceIndex/en/ (accessed October 2008). In some countries, such as the United States, food prices increased only about 20 percent in the same period, which was roughly the same as the consumer price index.

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show that a 1 percent rise in the ratio of the elderly to workers in the economy results in a decline in the ratio of savings to GDP of more than 0.3 percent.[11] Under even the most optimistic assumptions, the savings rate in the OECD countries in 2040 will be only slightly more than half the 2000 level (or even lower under more realistic assumptions). This means that economic growth of the OECD economies, in turn, will be considerably lower, other things being equal. Since economic growth often leads to higher employment and raises incomes of disadvantaged groups, the decline in economic growth will remove an important social lubricant. As a result, tensions between income groups may rise in the future. To avoid increased political repression, alternative institutions for alleviating such economic problems may have to be devised.

b. Microeconomic Volatility. Volatility can arise at the microeconomic level as well as the macroeconomic.

[11] The results of various empirical studies of the impact on savings of a rise in the elderly as a share of the population are summarized by Robert Stowe England in *The Macroeconomic Impact of Global Aging* (Washington, D.C.: Center for Strategic and International Studies, 2002). For a simulation model of the U.S. economy that takes these effects into account, see Frederic L. Pryor, "Demographic Effects on Personal Saving in the Future," *Southern Economic Journal* 69, no. 3 (January 2003): 541–60.

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In the United States, for instance, certain microeconomic volatility measures have increased in the last third of a century, and a number of studies suggest that family incomes vary much more from year to year than they used to,[12] a phenomenon which puts affected families at greater risk. Risk has also risen for American families who find it hard to obtain affordable health insurance because of their preexisting health conditions or because their pensions are switching from defined-benefit to defined-contribution plans (such as 401 (k) plans).[13] This trend may, however, be modified by the health care bill signed into law in 2010, although, at the time of writing, it is difficult to know if this law will survive legal challenges. Of course, those living in capitalist countries with established universal health insurance or with predominantly defined-benefit pension plans do not face these

[12] Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, in "The Evolution of Household Income Volatility," *Finance and Economics Discussion* Series no. 61 (Washington, DC: Federal Reserve Board, 2007), present their estimates of this volatility and also provide an extremely useful survey of previous work on the topic by others.

[13] Peter Gosselin, in *High Wire: The Precarious Financial Lives of American Families* (New York: Basic Books, 2008), discusses a wide variety of other mounting financial risks faced by American families. Unfortunately, I have been unable to find comparable data for other OECD nations.

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risks. Unfortunately, comparable long-term data on volatility of family incomes for other OECD countries are not available, but such data might reveal a similar increase in microeconomic volatility because foreign trade has a larger role in their economies.

c. Changing Relations Between Capital and Labor. Until recently, trends in the ownership and management of enterprises did not point toward dramatic institutional changes in production institutions.[14] During the financial crisis starting in 2007 and 2008, however, many governments bought shares in

[14] Three quite different indicators can be used to examine these issues: monopolization, as measured by the degree to which the top four or eight firms dominate the shipments of a narrowly defined industries; agglomeration, as measured by the share of total employment or industrial assets accounted for by the largest one hundred or one thousand firms; and the average size of enterprises, as measured by labor force or assets. Despite the growing number of mergers between enterprises, particularly in the 1990s, trends in these indicators in the latter part of the twentieth century give no cause for alarm and portend little dramatic change in the coming decades. In Pryor, *The Future of U.S. Capitalism*, *op. cit*. I discuss U.S. evidence on these matters; for Europe over a shorter time period, see Mikael Stenkula, "The European Size Distribution of Firms and Employment." Research Institute of Industrial Economics, IFN *Working Paper* no. 683 (Stockholm: RIIE, 2006).

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enterprises – primarily banks, but in some cases producers as well – to provide them with liquidity and to prevent bankruptcy. At the time of writing, it is unclear whether such steps toward "socialism" will be reversed after the economy recovers or whether they represent a new direction and will be extended to other sectors of the economy. In brief, will the General Motors Corporation (GM), which was partially nationalized in 2009, be known in the future as "Government Motors?"

Labor markets may change as the labor force becomes more and more heterogeneous in terms of skills, ethnicity, and lifestyle. In most OECD nations, working-class solidarity appears to be declining, as manifested in a falling share of unionized workers in the labor force.[15] The weakening of labor unions has led to greater wage inequality and less job security, trends reinforced both by rising imports of labor-intensive goods from developing countries that pay much lower wages and by an increased willingness by employers in many countries to use wage

[15] Several of the *Nordic* countries are exceptions to this generalization. Underlying data are provided by Miriam Golden, et al., "Postwar Trade-Union Organization and Industrial Relations in Twelve Countries," pp. 194–230 in Herbert Kitschelt et al., eds., *Continuity and Change in Contemporary Capitalism* (New York: Cambridge University Press, 1999); and Jelle Visser, "Union Membership Statistics in roughly 24 Countries," *Monthly Labor Review* 129, no. 1 (January 2006): 38–49.

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differentials as part of incentive packages to encourage more work from their employees. These trends reinforce the growing income inequality arising from higher relative prices of foodstuffs and raw materials.

C. Types of Systemic Change

In Chapter 4, we delineated four distinct economic systems of advanced capitalist nation, defined in terms of clusters of complementary institutions. This result suggests a certain "logic of institutions." That is, an economic institution cannot be wildly out of sync with all the other institutions in the economic system. Thus, as a system changes, all of its institutions must change in a related fashion at roughly the same time. An empirical demonstration of this concept using the various institutional characteristics presented in *Economic Freedom of the World* shows that institutions and policies associated with different facets of economic freedom change together both over time and also across countries at the same time.[16]

[16] The calculation is carried out by Russell S. Sobel and Christopher J. Coyne in "Cointegrating Institutions: The Time-Series Properties of Country Institutional Measures," submitted for publication, 2010. Their data on institutions come from James D. Gwartney and Robert A. Lawson, *Economic Freedom of the World* (Vancouver: Fraser Institute, 2008).

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Three critical questions arise from such considerations: If institutional changes occur in OECD countries, will the same countries remain in the same economic system, that is, will they still cluster together? Will nations with the same economic system become even more similar? And will the different economic systems tend to converge?

These questions concern complex changes over time, and an empirical study to answer them by delineating economic systems in past years is difficult to carry out because we have few quantitative measures of institutions before 1990 – in fact, I could locate only eleven. Although we cannot hope for conclusive answers, we can obtain some tentative and tantalizing results.

1. Parallel versus Random Systemic Change

The "logic of institutions" suggests two types of parallel change to investigate. The first is *parallel institutional change*, which occurs when the clustering of countries in economic systems remains the same, even though the individual institutional components of these systems (or the measures of these institutions) have changed in value. For instance, over a given period, the ratio of public expenditures to GDP in the *West European* countries can always be higher than that in the *mostly Anglo-Saxon* group of nations, even though the values of these ratios

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vary considerably at different points in time. These parallel changes can be contrasted with random institutional change, which occurs when changes in the institutional indicators follow a haphazard pattern and are quite different among countries that formerly had the same economic system.

Did the OECD nations manifest parallel or random institutional changes? Since these nations had largely recovered from the effects of World War II by the end of the 1950s, I start the analysis with data for four benchmark years thereafter, namely 1960, 1970, 1980, and 1990, and then determine the rank orderings of the average values of the four economic systems for each of the eleven institutional indicators in the benchmark years.

The test results are clean. For ten out of the eleven institutional indicators, the rank orderings of the averages of the four economic systems were the same in all four years. In sum, the OECD nations have exhibited parallel institutional change. Nevertheless, important changes in the values of these indicators occurred. For instance, the ratio of public consumption to total (public plus private) consumption in the *Nordic* nations was roughly the same as the OECD average in the early 1950s, but it had moved ahead of all other OECD systems by 1960, and in the following years this gap widened even more. Thus, a distinctive characteristic of the current *Nordic* economic

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system – their welfare state – began to emerge only in the mid-1950s, even though the ideological seeds may have been planted decades earlier.

One immediate objection to this analysis of parallel institutional change can be raised. The comparisons involved cover only thirty years, and the relationships might not hold over a longer period. For instance, data on public expenditures extending back to 1870 show sharp breaks in the rank ordering of nations before and after World War II.[17] Similarly, with regard to the openness of foreign trade, as measured by average tariff rates, the rank orderings of the four groups of nations greatly changed over the last 120 years, showing sharp breaks after both world wars.[18] This indicates that the logic of

[17] The underlying data come from Thomas R. Cusack and Susanne Fuchs, "Parteien, Institutionen und Staatsausgaben." In Herbert Obinger, et al., eds., *Politische Ökonomie: Politik und wirtschaftliche Leistungsprofile in OECD Demokratien* (Opladen: Leske und Büdrich, 2003), 321–54 However, I have had to make a number of estimates to extend some of the series back to 1870. Peter H. Lindert, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* (New York: Cambridge University Press, 2004), shows that many of the differences in the rank orderings among nations can be traced to changes in the extent of the voting franchise and the degree of democracy.

[18] The graph of the degree of trade openness over time is complex. Tariff rates in a worldwide sample of thirty-five nations slowly rose from the 1870s to the first decade of the twentieth century,

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institutions is a phenomenon primarily relevant just in the short and medium runs. Of course, this makes long-run prediction of changes in economic systems more difficult.

The second type of parallel change is *parallel country change*, which occurs when countries with the same economic system remain clustered together at different points in time when all institutions are taken into account, even as the pattern of their complementary institutions changes. In contrast, random country changes occur when countries that clustered together in one period cease to do so later. This happens when countries

then rose dramatically from the 1920s to the late 1930s, so that at their peak they were roughly twice as high as the late-nineteenth-century average, and then slowly declined from the late 1940s to the 1990s. See Christopher Blattman, Michael A. Clements, and Jeffrey G. Williamson, "Who Protected and Why? Tariffs the World Around 1870–1938," Harvard Institute of Economic Research *Discussion Paper* no. 2010 (Cambridge, MA: HIER, 2003). During these three periods, the relative position of countries changed considerably. For instance, the U.S. was a high-tariff nation in the late-nineteenth century, but in the interwar period (up to the enactment of the Smoot-Hawley tariff bill in the early 1930s) had relatively low tariffs, compared both to previous eras and contemporary rates in other countries. Obviously certain changes in the external international economic environment have also been important, such as the influence after World War II of the GATT treaty (General Agreement on Trade and Tariffs) and the creation of the European common market.

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in one system that had higher quantitative measures for particular institutions than those of another system no longer manifest such differences in the next period.

To examine parallel country changes, I employ a cluster analysis to determine the economic systems in each of the four years under investigation. Unfortunately, the eleven indicators available for the historical analysis are not necessarily representative of the entire economic system.[19] In fact, for the overlap year 1990, an eleven-indicator comparison placed only three-quarters of the countries in the same clusters into which they fell when a forty-indicator comparison was used. In the 1960–1980 period, between 48 and 57 percent of the countries were found in the same clusters to which the forty-indicator analysis for 1990 had allotted them.

These results are not conclusive, and three interpretations can be offered: (1) *parallel country change* occurs, but it is not very strong; (2) the eleven indicators are really not representative of all the key economic institutions; or (3) economic systems are mutable over time. Case-study materials can provide some clues, so let us focus on the case of the United Kingdom in the postwar period, a

[19] This discussion draws upon evidence presented in Frederic L. Pryor, *Economic Systems of Foraging, Agricultural, and Industrial Societies*, *op. cit.*, Chapter 7.

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well-known example of a country experiencing considerable systemic change.

In a survey of a group of specialists in economic systems, a majority rated Great Britain in the early 1960s as having more national planning and government direction of the economy than most other OECD nations.[20] My own cluster analysis using eleven institutional indicators placed the United Kingdom in the *West European* system in 1960 and not the *mostly Anglo-Saxon* system, which has had a more laissez-faire economic system. For the late 1990s, a much more systematic study, using both a survey of laws and observer opinions, put the United Kingdom among those OECD nations with the least governmental participation in the economy.[21] Correspondingly, my own analysis of the same eleven indicators in 1990 also placed the United Kingdom among those with a *mostly Anglo-Saxon* economic system. In brief, over the thirty years from 1960 to 1990, the capitalist economic system of the United Kingdom had greatly changed.

The high degree of government intervention in the U.K. economy in the 1950s and early 1960s might be

[20] Myron H. Ross, "Fluctuations in Economic Activity," *American Economic Review* 55, no. 1 (March 1965): 158–61.

[21] Giuseppe Nicoletti and Frederic L. Pryor, "Subjective and Objective Measures of the Extent of Government Regulation," *Journal of Economic Behavior and Organization* 59, no. 3 (2005): 433–49.

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attributed to the self-reinforcing process of a slow wartime recovery and inertia in removing inappropriate wartime controls of the economy. But disappointing economic performance in the first three decades following World War II resulted in a shift in the balance of political forces and, most likely, in ideology as well. In analyzing the U.K.'s economic system, most commentators have focused on the 1979 election of Margaret Thatcher, whose government sold off state enterprises, reduced labor unions' influence in national economic policy making, and, as briefly noted above, cut back the governments' other roles in the economy. In 1990, her last year in office, the economic system of the United Kingdom had become like that of other nations in the *mostly Anglo-Saxon* group. But if we look at the eleven historical indicators discussed above, this process appears to have begun in the mid-1970s: Thatcher's policies appear, in part, as the culmination of a previous trend.

The lesson from this example is that a country can change its economic system, even if the changes in particular institutions are not well synchronized with other institutions. This requires, however, that the political leadership be tough and strong, follow consistent policies, and be able to maintain enough political support for a sufficiently long period to overcome the resistance arising from the pain that such policies inflict because of

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the inconsistencies between institutions that have and have not been yet changed.

One can carry out other tests of parallel country changes, but the results come as no surprise.[22] The results above, however, show that parallel institutional change appears to be much stronger than parallel country change. Both types of change also provide support for the logic-of-institutions approach, at least in the short and middle runs.

2. Converging or Diverging Systemic Changes

Do economic systems tend to become more or less similar to each other over time? We can explore this long-term issue by first carrying out a cluster analysis of institutions in developing economies, using virtually the same institutional indicators as for the OECD nations. Then by comparing the average differences between the clusters in the two set of countries, as well as the degree to which these clusters explain the differences between nations with the same economic system, we can gain some idea about systemic changes over time.[23]

[22] Most importantly, these tests included a concordance analysis of the rank orders of countries.

[23] Frederic L. Pryor, "Economic Systems of Developing Nations," *Comparative Economic Studies* 48, no. 1 (March 2006): 77–98. The comparisons between the sample of OECD and developing

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The results can be quickly summarized: the clusters of the developing economies are further apart from each other than the OECD countries; moreover, the differences between same-system nations are greater in the former than the latter group of nations, that is, the individual clusters cover a much larger institutional space among the developing countries. In brief, both between-system and within-system distances are greater in the developing economies. This appears reasonable if we consider the much-different starting points at which the developing economies began to enter the modern age and the hypothesis, oft-expressed by modernization theorists, that industrial economies impose more constraints on economic operations than agricultural economies do. Agricultural economies are much less complex and have many fewer institutional interconnections.

When a similar test is carried out for the OECD nations with just the eleven available institutional indicators for 1960 through 1990, no apparent trends can be found in the between-cluster and within-cluster distances. Again, however, we are faced with a problem of interpretation: Are we getting these results because the eleven-institution sample is not representative, because

economies are made in Pryor, *Economic Systems of Foraging, Agricultural, and Industrial Societies*, *op. cit.*, Chapter 7.

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the time period is too short, or because convergence is solely a long-term phenomenon?

3. Speed of Change

Institutions can seem frozen in time. For instance, in the OECD nations, the measures of the central bank's policy independence from the Ministry of Finance showed little variation from the 1950s to the 1990s, that is, until the establishment of the European Central Bank. The most noticeable exception was the increasing policy independence of the *South European* central banks, which went from well below the OECD average in 1951 to about average in 1990.

In other cases, institutional changes were slow but apparent, and in one direction. For example, in the OECD economies governmental expenditures (both consumption and transfers) as a ratio of GDP rose steadily over this period from 26.3 percent in 1952 to 44.5 percent in 1990. Similarly, indicators of other institutions, such as worker protection against job loss and openness of trade in goods, services, and capital, also showed a steady increase over time.

In still other cases, institutional changes have been reversed: that is, the system changed in the short run but not in the long run. For instance, in the year immediately following the end of World War II, there was a

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strong wave of nationalization of industry in most OECD nations. In the ensuing four decades, however, public ownership of the means of production declined in most of these same nations.[24] As noted above, government ownership also increased during the financial crisis that started in late 2007, and this institutional change may (or may not) be temporary. Other cases of the rise and fall of particular institutions are more difficult to characterize.[25]

Finally, systemic change can sometimes occur quite rapidly. Military occupation and/or a political revolution can result in a dramatic and rapid overhaul of the economic system, as was seen in the first decade after World War II in Central and Eastern Europe. In these countries, the imposition of a new economic system, communism, was bloody and repressive. Rapid systemic change again

[24] Piet Angelo Toninelli, *The Rise and Fall of State-Owned Enterprise in the Western World* (New York: Cambridge University Press, 2000).

[25] For instance, it is sometimes argued that corporatist institutions reveal a similar rise and fall. Certainly, some trappings of corporatism disappeared in some European countries after the mid-1970s, following the oil shock and subsequent economic difficulties. Nevertheless, according to the research I reported in "Corporatism as an Economic System," *Journal of Comparative Economics* 12, no. 3 (September 1988): 317–44, the tide of corporatism was not ebbing in the OECD as a whole, at least up to 1990, even though such a trend is found in some OECD countries.

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occurred in this region from the early 1990s to the early 2000s after the fall of communism; and, while it was not bloody, it, too, was painful for large portions of the population.[26] Rapid systemic changes can also be triggered, as noted above, from defeat in warfare or a disastrous economic crisis.

For the industrial OECD nations, rapid systemic change seems unlikely in the foreseeable future. As one may infer from the previous discussion, there are few indicators (except for, possibly, the nationalization of industry) that we will see major shifts toward one particular type of capitalism rather than another. Furthermore, parallel country change seems likely to persist: in the near future the grouping of nations into particular economic systems will probably be quite similar to what it is today, as will the relative degree to which certain institutions are manifest in the various countries.

On the other hand, it also seems highly likely that the capitalist economic systems of industrial nations will gradually converge in the very long run. First, most of these nations belong to the European Union, which is trying to harmonize the business practices and laws of its member nations. Second, all of the nations belong to

[26] See Anders Åslund, *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Europe* (New York, NY : Cambridge University Press, 2007).

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certain international organizations, such as the Bank for International Settlements in Basel or the World Intellectual Property Organization in Geneva, which are likewise aiming for uniformity. Third, between the early 1950s and 2000, differences in the level of economic development (measured by per capita GDPs) of the various nations narrowed considerably, and this trend seems likely to continue in the future.[27]

D. Future Systemic Change in the OECD Nations

Having looked briefly at the types and processes of systemic change, we might try to speculate on exactly how these economic systems will be different in the far future. But while the discussion up to now of parallel institutional and systemic change, systemic convergence, and speed of systemic change may vary in the future, these concepts do not help very much in predicting particular changes in individual systems.

However, several ways to analyze future systemic changes are still open to us. Since we used forty indicators of economic institutions to define the four economic

[27] The data underlying this statement come from Angus Maddison, *The World Economy* (Paris: OECD, 2003).

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systems of the industrial OECD nations, we could examine how the forces underlying institutional change will impact each of the indicators. A less tedious method is to explore the most probable changes in what I believe to be the institutions most likely to experience important transformations. These changes mostly refer to industrial capitalist countries in general; only a country-by-country survey of laws and institutions can reveal which economic systems will be most affected.

1. Financial Sector

As indicated in Chapter 6, the world economic crisis starting in 2007/2008 was primarily triggered by events in the financial sector. If governments wish to avoid similar downturns in the future, the financial sector must experience important institutional and policy changes in the years to come. It is unclear, however, how large these changes will be, given the array of powerful political forces opposing any major modifications. Change might be confined primarily to regulation procedures, or it might go further and alter the structure of other sectors as well.

Regarding bank regulation, a recent IMF analysis of commercial bank performance in eleven OECD nations showed clearly that governmental regulation of bank liquidity and of the relative roles of bank-asset

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funding from deposits and from borrowing, significantly affected bank performance and failures in late 2007.[28] This suggests that if the regulatory regime is improved, major structural reforms may not be necessary in some countries.

Markets for various exotic derivatives, sub-prime mortgages, collateralized debt obligations, credit default options, and similar financial instruments will undoubtedly be more constrained in the future.[29] For instance, banks bundling many mortgages into a new securities may be required to retain a certain percentage of these

[28] Lev Ratnovski and Rocco Huang. "Why Are Canadian Banks More Resilient?" IMF *Working Paper* WP/09/152 (Washington, D.C.: International Monetary Fund, 2009). Another study by Andrea Beltratti and René Stulz, "Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation," The National Bureau of Economic Research *Working Paper* 15180 (Cambridge, MA: NBER, 2009) also shows the importance of certain regulatory policies, although it places more emphasis on bank governance as a factor of bank performance during the crisis period from 2007 up to 2009.

[29] It is noteworthy that Africa, where most countries limit the types of activities in which financial institutions can engage, was the only continent untouched by the recent financial crisis (at least up to the time of writing). This suggests one useful way in which the more "advanced" countries might change their economic systems.

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new securities, so that they will bear part of the risk of default and, thus, will be more conscious of the risks they are passing on to others. This percentage might also be adjustable by the central bank, just as some central banks can adjust the margin for individuals buying securities on credit. In addition, certain banking practices, such as "liar loans" (loans given with no investigation of the borrowers' stated income or ability to repay) (these were also called NINJA loans, indicating that borrowers had no income, no job, and no assets), or the sale of high-interest (sub-prime) mortgages to those with little ability to pay them off might be similarly restricted. Stricter controls may also be placed on the activities of hedge funds and other firms leveraging their capital by borrowing at low interest rates to speculate on allegedly high-yielding assets. It also seems likely that the degree of financial leveraging by banks, "nonbank banks," hedge funds, and the like, will also be further restricted. In brief, we can probably expect constraints on a great many financial activities, businesses, and individuals that heretofore have received little governmental pressure to reduce financial leveraging. Whether these measures will be sufficient to avoid the kind of economic shocks recently experienced by the world's financial sector remains to be seen.

Structural transformations of the financial sector, originating either internally or in response to government

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actions, may also take place in some countries. An important transformation occurring during the financial crisis that began in late 2007 was the considerable consolidation of banks in some OECD nations, as strong banks purchased weaker ones to save them either from illiquidity or bankruptcy. At that time, this trend did not cause great alarm since some econometric evidence suggests that countries with more concentrated banking structures are less likely to experience banking crises.[30] Nevertheless, increasing concentration of the financial sector can, in some cases, lead to increasing concentration of investment or production, which has negative consequences. The growing importance of sovereign wealth funds (investment funds controlled by governmental agencies) in certain nations with large deposits of raw materials and oil tends also to promote centralization of the financial sector. Although governmental actions can limit concentration of the financial sector, it is unclear whether these steps will be taken.

2. Government Sector

In major respects, the power of governments to influence aggregate economic activities will become weaker.

[30] Thorsten Beck, Asli Demirgüç–Kunta, and Ross Levine, "Bank Concentration, Competition, and Crises: First Results," *Journal of Banking and Finance* 30, no. 5 (2006): 1581–1603, presents evidence for this claim.

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Such a process can already be seen in federal countries, such as the United States or Germany, where the subordinate governmental units (for instance, the states of the United States, Länder in Germany) have little impact on macroeconomic aggregates in their areas of jurisdiction. Moreover, as we saw earlier, increasing globalization will probably lead to greater aggregate volatility since globalization makes nations more vulnerable to economic shocks originating abroad. At the same time, moreover, the national governments will have fewer macroeconomic tools with which to offset cyclical swings because the increased volume of imports will diminish the impact of governmental intervention. That is, more of the new purchasing power (money) pumped into the economy by the government to offset declines in consumption will go abroad rather than circulate internally. Similarly, attempts by governments to stimulate investment by lowering interest rates may speed up the outflow of investment funds to countries with higher interest rates. The governments of the European OECD nations have essentially handed over their monetary power to the European Central Bank, which may not be willing to take interest rate actions that would affect all countries in the monetary union just to assist a few distressed countries.

Globalization will lead to a similar weakening of regulatory powers, as countries are forced to coordinate their

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microeconomic policies – either through a supranational organization, treaties, or by very frequent contact. National regulations are also enfeebled by the increasing importance of services, which are difficult to control because of their heterogeneity and complexity. For instance, a contributing cause of the 2007/2008 financial crisis was the sale of derivative securities by financial companies. These securities were so complex that few people – including the professional rating agencies – were able (or willing) to assess their risks. In the United States, the institutions selling such securities did not care about the risk as long as it could be passed on to others, and when the liabilities could not be paid off, a chain reaction of bankruptcies began.

But just as governments find themselves less able to control the economy, citizens will be expecting them to do more: they will demand governmental actions that protect family income from the greater volatility accompanying globalization, especially since individuals can not easily take countermeasures by themselves. Such governmental policies would include both direct transfer payments and various indirect actions such as greater regulation of private pensions and more constraints on markets for consumer goods and services. Many of these measures, which have been in place in the *Nordic* countries, will have to be introduced in some of the other economic systems as well.

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During the global recession starting in late 2007, the share of public expenditures in the GDP rose to stimulate the economy by providing additional purchasing power, to bail out various financial enterprises and other enterprises, and to pay for greater welfare expenditures. How long these additional expenditures will last is, at the time of writing, unknown. However, it seems certain that the share of public expenditures in the GDP will rise in the future, driven by the rising ratio of the elderly to those in the working cohorts and by the rising costs of medical care as increasingly expensive cures are brought on line. Of course, countermeasures could be taken: raising the retirement age and/or the age at which pensions from the social insurance system are received; reducing the per capita amount of these payments; rationing the medical services financed by the government; or cutting back on other government expenditures, such as education, defense, agriculture, or economic regulation. Politically, however, these steps are very difficult to take and elected governments propose or implement such measures only at their peril.

3. The Labor Sector

The political and economic power of workers seems to be trending downward in most OECD nations. The share of union workers has fallen in most countries, a trend that is likely to continue as service workers become an

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ever-rising share of the labor force. In some – but not all – OECD nations, this weakening of workers' power can also be seen in the declining share of labor income in the national income (after removing the labor income of corporate officers)[31] and a widening wage inequality, abetted by an ever-increasing downward pressure on the wages of low-skilled workers as labor-intensive imports from developing countries that pay their workers lower wages enter the market.

As noted above, the aging of the population in the OECD nations will result in less net saving and lower economic growth. This may well exacerbate the social tensions arising from widening income inequalities because countries will be less able to alleviate poverty through economic growth alone. A fraying of the social fabric may also result from the growing heterogeneity of the population that is brought on by immigration. For instance, studies show that democratic governments in areas with more heterogeneous populations spend less on social services and education. On the other hand, alienation from the government, as manifested by such indicators as the willingness of people to cheat on their taxes, does not seem to have changed very much for

[31] For the United States, relevant data are provided and analyzed by Philip Jefferson and Frederic L. Pryor, "Dynamics of U.S. Factor Income Shares," *Journal of Income Distribution*, 19, no. 1 (March 2010).

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the OECD as a whole, at least in the 1990s.[32] Again, we face the problem that we can identify general systemic changes without being able to determine exactly how individual systems will change.

4. A Brief Summary

The discussion up to now has provided a general flavor of possible future changes in the economic system. Each nation or economic system has its peculiar circumstances, of course, and predicting the individual trajectories of each is beyond the scope of this the present survey. Therefore, discussion in this chapter has focused on the direction of general changes in institutions rather than to specific changes in particular countries or systems.

While we can point to imperfections in current institutions that compose the economic system and speculate on how they can be improved, it is much more difficult to determine how any changes taken will fit together, especially since modifications in one institution may

[32] Ronald Inglehart et al., *Human Beliefs and Values* (Mexico City: Siglo XXI Editores, 2004), present survey data for many nations on responses to the question of whether it is justifiable to cheat on one(s taxes if one has a chance (question F116). For the OECD nations between 1990 and 2000, no significant change in responses occurred, even when per capita GDP and economic system are held constant.

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influence the performance of another. For instance, alterations in the financial system may lead to less investment and economic growth, which, in turn, can affect the operation of the labor market. Thus, gaining insight into the operation of the entire system, which embraces many different but interconnected, institutions, is a particularly difficult task.

Recent election campaigning in various OECD nations leads to the unfortunate conclusion that few politicians have a sufficiently consistent vision of the future economic system to make wise policy decisions or to implement a consistent program for changing the economic system.

E. Parting Words

This short book has covered a great deal of territory. We have seen why capitalism emerged in northwestern Europe in the nineteenth century rather than in other parts of the world. There were a variety of enabling factors in Northwestern Europe, including a higher level of economic development, a system of law and order that more or less prevailed, protection of private property, the existence of institutions that helped to spread new technological knowledge, and national governments that generally provided the necessary roads and other overhead

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capital but did not greatly interfere in production. Among the current industrialized nations of the OECD, we saw how the configurations of economic institutions lead us to delineate four economic systems.

The economic and social/economic performance indicators of the OECD countries in the sample fall into the same distinct country groups as the countries in the economic and social systems. Although these economic systems do not greatly differ in their performance, they do show considerable differences in their social/economic outcomes. In the economic sphere, for instance, although the *mostly Anglo-Saxon* nations have significant investment efficiency (that is, higher output per unit of additional investment), but also greater income inequality at high incomes and higher levels of air pollution, they do not significantly differ in most other performance measures. In a given economic system, countries that score higher for a one set of performance indicators may score lower than countries than other economic systems for a different set of indicators, so that a trade-off of performance variables seems to occur. We could not, however, find any evidence that any of these economic systems produced happier people.

Barring cataclysmic economic events, we can expect current OECD economic systems to evolve slowly and in a piecemeal fashion, with changes in a few institutions

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occurring in one period, followed in subsequent periods by adjustments in other institutions. Although it is difficult to make predictions, I have tried to point to those areas in which system change is most likely to occur in the fields of finance, government, and labor.

This reassessment of capitalism allows us to reconsider the big questions about our economic system: What is capitalism? How does it usually perform? Where is the system going, and do we need to change it totally to avoid a repetition of our current economic difficulties? I hope that I have provided a new perspective from which to address these questions. It is my hope that this book has provided fresh insights into capitalism and on some potential changes to this system that may happen in the future.

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