

Capitalist Systems are Societal Constructs: Not “Clouds” or “Clocks,” but “City States”

A Review of Does Capitalism Have a Future? by Immanuel Wallerstein, Randall Collins, Michael Mann, Georgi Derluguian, and Craig Calhoun (Oxford University Press, 2013)

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Does Capitalism Have a Future? is the work of five distinguished senior authors addressing the future of capitalism and its recent past. Their book warns that “something big looms on the horizon: a structural crisis much bigger than the recent great recession. Over the next three or four decades, capitalists of the world may simply find it impossible to make their usual investment decisions due to overcrowding of world markets and inadequate accounting for rising social costs. In this situation, capitalism would end in the frustration of the capitalists themselves.”

The authors have chosen a very broad and important topic that suggests the need for skillful conceptualization, patient historical research, and well-informed, multidisciplinary analysis, all of which inevitably makes for a difficult read. At the same time, I fear that the book’s “bad news” for society might incline some readers to want to “shoot the messengers.” Nevertheless, in my view, these authors deserve credit for having the courage to report the “bad news” they foresee for the future of capitalism and for making some very far-sighted observations about their topic—most significantly, that *capitalism is a system of political economy and not just the economics of markets*. I agree wholeheartedly. In addition, I applaud their assertion that capitalist systems frequently have significant unrecognized costs (externalities) and that the employment prospects for its middle classes are being challenged as never before.

Now, some two years after publication of *Does Capitalism Have a Future?*, there is news in the financial press that seems to lend significant support to the authors’ pessimistic prognosis. The *Financial Times* recently reported (Luce, 2015) that U.S. capitalism is now using its major stock markets as avenues for the return of investor capital through the repurchase of their own stock via a practice that reduces capital investment relative to GDP, and thus the prognosis for longer-term growth. This strategy will permit companies to shrink their capital base in the face of declining growth and investment opportunities while maintaining share prices. Although the authors were concerned that such a

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shortfall in investment might occur in the decades ahead, with deleterious effects on the worldwide performance of capitalism, available data suggests that this process has been occurring in the U.S. since 1982, which in turn suggests that this problem may not be so much for the future or with the global capitalist system as for the present and recent past and at the same time focused on the United States. I will withhold elaboration on this topic until later, but I want to call our attention to the fact that this particular aspect of their prognosis has already been traced to U.S. firms buying back their own shares thanks to deregulation of its stock market. Furthermore these actions were designed to prop up share prices for the benefit of a tiny, wealthy elite group of officers, directors and other shareholders, rather than for the benefit of the system as a whole, as I explain later. Ironically, the authors were prescient in anticipating declining returns to capitalism, while overlooking that it has already been happening for reasons much like those they suggest, and for the past thirty years. I will build toward an analysis of what has already happened to U.S. capitalism and what those changes might imply for the U.S. and, indeed, for other capitalist countries.

Although I share a number of the authors' concerns about the future of capitalism, including the possibility of a very serious and long-lasting downside, I am not much persuaded by their historical research or their conceptualization of the dynamics of capitalism. In addition I am frankly disappointed by their failure to note the declining economic performance in the world's largest economy when the causes seem so close to those they were anticipating. Indeed they simply do not distinguish among capitalist countries, or consider nation states important; it is as if there is only one version of capitalism, which in my view is to overlook a very important characteristic of the territory which they have studied. Thus, in my view this book review invites a very thorough look at capitalism and how it can best be conceptualized, researched and analyzed.

First, in attempting a global analysis of the recent past of capitalism, it seems to me that the authors have all but overlooked the "elephant in the room", which is none other than the U.S. version of capitalism. The U.S. is the largest and, traditionally, the richest of the capitalist economies in the world, and the unquestioned model of effective capitalism for most Americans. Unfortunately U.S. policy makers, let alone politicians, have not been inclined to acknowledge—let alone to probe deeply—its potential for systemic problems, such as those envisioned by the authors or revealed by the *Financial Times*. Second, the problems now emerging in U.S. capitalism are pervasive, stretching from unfortunate choices of internal governance models for its firms to excessive reliance on de-regulation of its economic markets as though deregulation itself was a panacea for the market frameworks of its capitalism. When coupled with the introduction of a culture of one-way upside bonuses and a transformation

from stakeholder capitalism to shareholder capitalism, the character or culture of the U.S. economy has changed from an “inclusive” form of capitalism-compatible social democratic governance to a variant of capitalism that is “extractive” in favor of an oligarchic elite and, therefore, a real challenge to U.S. democracy as well as its ostensibly capitalist model.¹

Indeed, I believe that some of the most severe problems facing U.S. capitalism are better understood as problems of its overlap with U.S. democracy, where political governance has also been deregulated as if markets are a panacea in the political domain as well. This deregulation, dating from the 1970s, has paved the way for a mutual transformation that has corroded both its capitalism and democracy. If my suspicions are even somewhat prescient, then careful analysis is necessary to understand how and why some of these downside trends may have been allowed to develop in the U.S. In my view, such preparation requires, at a minimum, a more robust and dynamic conceptualization of capitalism and its evolution—notably, in the US—which I believe to be an extreme version of a shortsighted, extractive version of this system of governance for economic systems in comparison with other leading industrial countries. Thus, my call for a more robust and dynamic analysis of capitalism is not advocacy for an academic luxury of theory-building, but for additional research absolutely central to better understand its strengths and weaknesses as a platform from which to assess its future prospects. The central problem, so far as I am concerned, is that the dynamics of capitalism have been very poorly understood and that the academic community shares a major responsibility for some ill-conceived theories and superficial research, too often disguised in mathematical modeling as though such models are the essence of “social science.” Furthermore, many business leaders have failed to think deeply about their capitalist systems, but perhaps they have some self-interested reasons for such misunderstanding.

In *Does Capitalism Have a Future?*, I believe that the authors’ basic conceptualization of capitalism is not just very much underdeveloped but faulty. Although they deserve great credit for their unanimous (and all-too-rare) view that capitalism is a system of political economy, they base their analytic framework on “macro-sociology,” broadly defined as “a sociological approach that analyzes social systems or populations on a large scale or at a high level of abstraction” (Calhoun, 2002). Using macro-sociology as an analytical framework is certainly not an obvious strategy for guiding either research or policy development on a capitalist system, which the authors recognize to be centered in political economy. In particular, they have adopted a framework which simply omits the governance of the principal economic actors of capitalism, namely, its

¹I use the terms “inclusive” and “extractive” as suggested by Acemoglu and Robinson (2012).

firms. They have also failed to note that capitalist systems are rooted in nation states, each with its own government: there is no such thing as a universal capitalist model. The authors choice of an analytic framework in macro-sociology strikes me as based on macro-sociological ideas of the past that were rooted in the analysis of broad cycles with little attention to specific countries; it brings to mind Mark Twain's famous saying that "to a man with a hammer, everything looks like a nail."

Because the authors agree that capitalism is a system of political economy, it is their responsibility to bring an appropriate set of concepts and tools to bear on their topic. First, at a minimum, the study should have been multidisciplinary. I believe that their choice to rely on macrosociology for the analytic framework represents a major shortcoming; I am much less troubled by their pessimism than by their conceptualization of their subject matter. Second, I find some of the book's most acute problems lie in neglecting the changing dynamics of the *micro*-sociological relationships that have taken place within the firms, which are, after all, the iconic economic actors of the system they are studying (a point which I will explain at length below). In addition, the authors should have featured the important yet unexplained role of the purposeful, micro-level human agency of government regulators that is crucial to understanding the modernization of market frameworks and, thus, the behavior of firms in capitalist societies.

As a contrast, my study of capitalism began with field-based, case studies on the development of firms in eight countries in the early 1960s and '70s, and I coupled these cases with research on the economic strategies of comparable number of countries, i.e., the microeconomic and sociological impact on the iconic actors of capitalism, rather than on capitalist societies as such. I followed this with a three-year, country-wide study of the unique French experience of "indicative planning" for its business sector in the 1950s and 1960s and how they attempted to influence their "capitalist" system and, indeed, their firms. To my surprise, my co-researcher and I found almost no influence from this indicative planning on any of their firms. The French firms did their own planning for their own market frameworks while participating in a system which they regarded as mostly "window-dressing" (Scott, 2011a).

The notion of market frameworks, and how these frameworks might evolve with circumstances, is almost absent in the present book, and the role or roles any such frameworks might have on firms is simply not analyzed. In addition, the authors fail to identify a change in U.S. capitalism at the firm level, a feature that has made the U.S. distinctive from most other developed countries, since the 1970s, as I explain later.

An Inadequate Definition of Capitalism

The authors analysis should have started with an adequate definition of capitalism as a system, which they could build upon in their analysis. In my view, the core problem with the authors' approach stems from their definition of a capitalist system which simply fails to connect with the European historical context in which it emerged or the operations of firms as a micro unit of analysis. In the initial essay, Professor Wallerstein relies on two key tests.

First, it must be a system and, for (that) system to be considered a capitalist system the dominant or deciding characteristic must be the persistent search for the endless accumulation of capital. Second, for this characteristic to prevail 'there must mechanisms that penalize any actors on the basis of any other values or objectives such as those actors are sooner or later eliminated from the scene, or at least severely hampered in their ability to accumulate capital. (10)

Neither of these postulates is substantiated in their book, and, in my view, both are simply mistaken, for reasons I will explain shortly. Wallerstein also notes that systems have lives; any such system must have a beginning, a period of more or less normal operation, and then it must come to an end. He acknowledges that the book is only about how such systems operate and end: how they came into existence "is not our subject" (10).

I believe that all three of these conceptual choices were unfortunate. First, I do not believe that the search for maximum profits needs to be the top priority for any capitalist system or that it need be aimed at endless accumulation, and the authors do not offer any historical evidence to support their assertion to the contrary. Second, I do not believe that economic actors who have somewhat different priorities need to be marginalized or eliminated. It was unfortunate for such an important scholarly book to omit an historical analysis of when, where, how, and why capitalism emerged.

In my view, capitalism started in circumstances where access to financial resources was a vital resource for political survival and the independence of many societies but had little to do with the individual desire for intended accumulation of wealth. Access to wealth was surely important, but the need for the protection of societies was far greater than the opportunities—let alone needs—of individuals; borrowed capital was almost surely more important for financing countries than the savings or earnings of rich people or private firms. To explain, limited earned incomes and/or savings could be supplemented by borrowing funds on international markets, and, in fact, the leading countries in early capitalism were characterized by massive borrowing to finance typically

mercenary military forces. The historical circumstances at the time were of decisive importance.

Capitalism began in Europe in the years 1400–1800, which is widely recognized, and extensively described by Fernand Braudel (1982), among others. It arose under extraordinary circumstances in which it was an unplanned but nonetheless crucial outcome. In those 400 years, the number of independent political entities in Europe would decline by about 90%, from an estimated 300–500 in 1400 to only 40 in 1820. Europe was the only continent where anything like this consolidation happened.

In this constitutive era, most European political entities were faced with an existential problem of avoiding hostile takeover by a more powerful neighbor. This challenge was exacerbated by the breakdown of the long-standing monopoly of the Catholic Church of the market for personal salvation as the Protestant Reformation lit the fires of religious competition and persecution. Hostile takeovers could be very hostile and, indeed, traumatic. In these dangerous circumstances, borrowing capacity was the crucial source of financing for most of the militarily active European countries. Borrowing permitted rapid access to large amounts of cash for political entities with good “credit ratings,” and the debts could be paid off after the wars had abated. A modest number of specific city-states and medium-sized countries fashioned systems of governance that permitted them to devise a new type of socio-political response, enabling them to borrow money. This system came to be known as constitutional monarchy and replaced its absolutist predecessors—sometimes through revolutions. Thus, Venice, The Netherlands, and England (after 1688) had better credit ratings than absolute monarchies of the three great European powers of the time: France, Russia, and Spain. By creating political entities that were governed by constitutional monarchies, the early leaders in capitalism could borrow far more money for their size than absolute monarchies, often at about one-third the annual interest rates.

However, constitutional or limited monarchy was only a part of the solution; it took a state with a certain strength to survive. Whereas a small number of “Italian” city-states were early leaders in the establishment of limited monarchies, most were not supported by a state strong enough to provide both external and internal security (e.g., Florence, Genoa and Lucca). Venice seems to have been the first entity to demonstrate clear, sustained leadership as a capitalist “country” when it escaped a crippling internal coup such as those that afflicted Florence under Savorola and then the Medicis, or an external conquest such as the Milanese takeover of the Genoa. This continuity was essential for the establishment of the rule of law, which was, in turn, essential for the development of market frameworks, which were themselves essential to the development of

capitalism. However, such a city-state also needed local political leadership to build loyalty to a territory or a “tribe” as a political entity. Venice narrowly defeated an invasion by Genoa and executed an elected doge who tried to make the throne inheritable by his son. Venice succeeded in keeping control through elaborate councils of nobles, but at the price of greatly restricting the prospects for strong, individual leadership.

Venice started from a precarious position in terms of its human and natural resources, but it was able to establish and retain its quasi-independent status thanks to its position in a shallow lagoon that provided protection from attacks overland. As Venice developed, its territory was largely fashioned out of filled land before the era of power tools or transport—by hard work and, indeed, societal sacrifice for a common purpose. Venice came to be governed by very small political units, like neighborhoods, and then by seven small islands whose citizens decided to elect a duke, which meant that it became a “constitutional monarchy” circa 797. Despite its very humble beginnings, by 1500, Venice was threatening to become the hegemon of Europe until cut down to size by a five-power coalition called the League of Cambrai, which was mobilized by the Pope. and included France,

Through skillful diplomacy, Venice avoided a “hostile” takeover, but still lost its independence in 1797. Even so, Venice can claim to have enjoyed the longest experience in the world with such constitutional government, beginning about 100 years ahead of its closest successful follower, The United Provinces of the Netherlands. The Netherlands also set up a constitutional monarchy while meeting the challenge of developing its dry land as well as institutions of governance. Venice led all countries in Asia, Africa or in South America by at least 400 years when it came to constitutional governance, and as a consequence, it led with capitalism as well. However, Venice never became a democracy; as it conquered territory, new inhabitants were not given the rights of citizenship enjoyed by the descendants of the inhabitants of its original islands.

To appreciate how Venice’s early history could foreshadow the rise of capitalism, you need only look at the spectacular capitalist success of the city-state of Singapore since World War II. Like Venice and a number of the other early success stories, Singapore faced a dramatic existential challenge from the clear political dominance of an internally-based Communist Party that had gained power and legitimacy as the foremost opposition to the Japanese forces of occupation in World War II. The challenge came in 1955 as the British forces prepared to “downsize” their colonial empire by allowing its various colonies to adapt to the new responsibilities of self-government. To avoid the perils of a transition to “one person, one vote, one time,” the non-Communist Chinese in Singapore had to consolidate their power by controlling the police and military

without becoming known as the “stooges” of the ex-colonial regime. Lee Kwan Yew and his fellow PAP party members saw that a merger of Singapore with Malaya would provide the new combined regime with a legitimate, democratically-elected government, giving PAP a strong but not controlling role in an independent regime, plus the right to draw upon the retiring British establishment, including their secret police, to help arrest and imprison the Communists. When the Malays and the Chinese in Malaya subsequently clashed, Singapore was forced to fend for itself as an independent yet tiny city-state. Now, more than 60 years of PAP leadership has provided the critical component in Singapore’s formation of an effective, inclusive regime that transformed a small island floating in a dangerous neighborhood into an economic and military powerhouse with a regime that was, and still is (roughly speaking), a “one-party democracy.” It’s not for nothing that Singaporean government officials speak respectfully of Venice as a remarkably relevant developmental model for their city-state.

Because each capitalist system is headed by its own political authority, each is to some extent distinctive or exceptional. So it would have been very helpful if the authors had discussed distinctive characteristics of several capitalist systems in order to illustrate the nature and importance of their common characteristics as well as their differences. Instead, they have given us an overall, “macro” view with remarkably little texture to appreciate, let alone explain, the success or failure of any country or political entity.

Given their somber views of the future of capitalism, the authors should also have addressed its possibilities for economic and political reform through existing political processes, which they implicitly recognize as inherent to the system, but about which they say very little. I believe this oversight gives strong evidence to support my belief that the authors are symptomatic of an academic community that has paid inadequate attention to the case-based, multi-disciplinary historical research necessary to understand how capitalism initially came into being and developed, let alone to understand the nature of the reforms that might now be appropriate.

In the absence of an appropriate formal model, a metaphor for how social systems emerge and/or develop would be valuable. Metaphors can help, even if only “so much.”

A Metaphor for the Development of Capitalist Societies

Karl Popper, a famous philosopher, once suggested “clouds” and “clocks” as contrasting metaphors for improving the visualization of differing types of inanimate systems. In a recent *New York Times* article, David Brooks presented a helpful discussion of such systemic metaphors based on his reflections on the

contrast between Popper's clocks and clouds as metaphors we can use here. According to Brooks,

Clock problems are typically quasi static systems which can be divided into parts and analyzed deductively, but cloud problems are indivisible and emergent systems. A culture problem is a cloud, so is a personality, an era and a social environment. Since it is easier to think deductively, most people try to turn cloud problems into clock problems, but a few people are able to look at a complex situation, grasp the gist and clarify it *by naming what is going on*. Such people tend to possess..., the ability to live with ambiguity and not leap to premature conclusions. They can absorb a stream of disparate data and rest in it until they can synthesize it into one trend, pattern or generalization. Such people can create a mental model that helps us think about a cloud like phenomenon.

Metaphors are simplified pictures that help one view and understand a complex reality, such as that of how a system operates and/or develops. Ideally, such simplified pictures of reality come close to the real thing without unduly distorting essential characteristics of the system under consideration. They lack the (sometimes artificial) precision of numbers, but, still, there is always a risk of oversimplification. In my view one of the most serious examples of the reduction of clouds into clocks occurred with the splitting of the academic field of political economy into the "disciplines," or "social sciences," of economics and political science, which occurred near the end of the 19th century; since then, this separation has become the unquestioned base for academic specialization of two fields of study whose separation has become deeply entrenched. That division has very real implications for this book review. Economists opted for the study of clocks, not just with deductive logic, but with increasing reliance on mathematical modeling of quasi-static systems. A crucial component of this change was the reduction of people to atomistic, homogenous, and rational "economic maximizers" (psychological and sociological data to the contrary notwithstanding) until the relatively recent "discovery" of "behavioral economics," that is, the rediscovery of real people. Correction of distorted economic models, including the correction of some of the notions of how markets work, is clearly one of the requisites for better understanding our economic systems. I will return to this analysis below when we look at the role of property and law in markets

Some might argue that the intellectual foundation of clock-like, self-regulating economic systems stems from Adam Smith's postulation of an "invisible hand" that could spontaneously coordinate the actions of buyers and sellers through

markets in ways that were more or less optimal for society. In one way, such an argument is simplistic, having little or no regard for Smith's prior work, *The Theory of Moral Sentiments*, which recognizes human differences. Smith's idea that decisions of buyers and sellers could be coordinated as if by an invisible hand was truly ingenious, but it has taken us a long time to recognize the driving force coordinating supply and demand was and still is the price mechanism. The notion of an "invisible hand" can support coordination but cannot support the notion of governance, where institutions can be modified or contract relationships can be changed, although economic fundamentalists like Alan Greenspan are wont to ask it to do just that.

Such reductionism completely ignores another fundamental truth. Supply and demand pertain to market operations, but not to the structure of the markets themselves. Coordination of supply and demand does not determine what is property, or how to understand the contracts involved in trading relationships that provide essential structure to markets. In fact, property and contracts form the building blocks of the legal system; their relationships are the antithesis of a self-regulating system. The laws that underpin property rights and contractual terms are formulated by legislatures and administered by regulatory agencies: they are subject to the *visible* hands of government agencies and, thus, to the very forces that Smith was trying to diminish, if not obliterate. Property rights and trading relationships are embodied in market frameworks and they do not ordinarily adjust with supply and demand.

Paradoxically, the invisible hand is susceptible to having its role extended far beyond its competence, which conveys a false sense of self-governance under which those with money presume that superior financial power justifies superior market outcomes; at the extreme, the superior market power of the rich seems to become "natural law," beyond societal control.

Understanding the future of capitalism creates a cloud-like conundrum that needs to be recognized. Capitalism is based upon socially-constructed systems subject to the very forces of political economy upon which the authors rightly agree but which the cloud-clock typology cannot adequately capture as systems. Capitalism has the coordinating powers of a clock when it comes to supply and demand; it can bring supply and demand into equilibrium through the pricing mechanism, and this process can be mathematically modeled. However, capitalism has the emergent properties of clouds when it comes to recognizing the political forces of legislatures, with their unpredictable majorities. *Capitalism also has the potential to be reshaped by autonomous human intentions as changing conditions and societal priorities indicate, which cannot be matched either by clocks or clouds.* Political economy is needed and also the micro sociology of work groups which may or may not be hierarchically organized.

To deal with political and social realities, I propose adding a third metaphor—a third “C,” the city-state. Of course, city-states used to be much more important than they are today, but Singapore certainly provides a powerful, modern example of just how much a society can accomplish through the governance of its own resources. Furthermore, its political and social relations illustrate various forms of reciprocal (non-market) relationships, such as how they evolve through time under human guidance, including the potentially conflicting guidance of organized political parties in a legislature.

It is my view that capitalism originated in Venice as an essential part of its rise to becoming the richest society in the world, circa 1400, remaining so for perhaps 200 years. The rise of Venice was not due to a leading position in the Industrial Revolution or to free trade. Instead, Venice was an exemplar of what could be accomplished through skillful management of a pre-industrial mercantilist trading system backed by state guidance and coordination, e.g., in the form of convoys to the Levant, and what was arguably Europe’s strongest navy. Indeed, it had state-owned and -managed merchant ships and the diplomatic and managerial skills to create a system of convoys for protecting their cargo spaces so they could be rented out to the highest bidders in the private sector. And from about 1400 onward, it had the benefit of a regulated banking system in which banks were required to hold a fraction of their investments in government securities. I did not find evidence of a central bank, but Braudel credits the Venetians with its equivalent in terms of regulation from 1404. This banking system gave Venice the ability to expand its financial power far beyond its holdings *in specie*, which was one of the key gains from this nascent capitalism.

Capitalism Is a Multi-Level System

Capitalism involves governance at two levels, one level for the society or state and the second for the various firms of differing sizes and vocations that owe their legal existence to a charter from the state. At the societal level, capitalism is a system of indirect governance based upon the articulation of rules for problem-solving in economic relationships. This indirect governance is effected through market frameworks rather than directly through hierarchy. On the other hand, firms are granted the powers of direct, internal governance through hierarchical structures. Firms are not normally subject to direct societal control, but they are permitted to use it for their own internal relationships. Successful capitalism depends upon creation and implementation of a multi-level system of governance for economic relationships where those who manage firms are allowed to have direct hierarchical (and sometimes even abusive) powers of governance within their own private space, but such powers are not permitted for government over the economy. At the same time, the powers of the firm to hire, fire, and perform

day-to-day management are based upon a grant of power by the state to govern a set of private actors. Thus, in one sense, private firms are “owned” by private shareholders, and ownership is conditioned firstly upon the firm meeting certain stipulations of responsibility laid out in the “charters of incorporation” and secondly in meeting the conditions set in one or more sets of market frameworks, which together constitute an indirect system of governance.

Part of the problem of attempting to precisely define this indirect system of governance for economic actors, mostly private firms, is that the indirect systems differ from one capitalist society to another; these differences complicate our ability to establish common rules for behavior among different national systems and sometimes even across differing political jurisdictions within a single nation. For example, although many countries have a single regulatory entity granting charters of incorporation, i.e., their central governments, the U.S. started with 13 different sources of such charters and subsequently increased that number to 50 and, in some circumstances, to 51. It is obvious that a charter granted by a central government can impose more demanding conditions than one imposed by one of 13 or 20—let alone 50—competing sources. For this reason, *no sociological framework, whether micro or macro, can adequately address the governance of capitalist systems*. The challenge of defining a global system that encompasses differing versions of capitalism is a conundrum that cannot be overstated.

Part of the authors’ analytic challenge was to determine how various nations and states evolved to explain their performance without succumbing to the ever-present temptation of oversimplification. The book before U.S. deserves credit for calling attention to a moving formation of clouds called capitalist economies; recognizing that each is an emergent system of political economy, somewhat like a city-state, and not just one of the all too clock-like quasi-static economic systems of markets; attempting at least a partial explanation of the patterns of governance that the authors discern; and then formulating some conditional, medium-term “weather forecasts.” To their credit, the authors are specific and emphatic on the point, “recognized by all of us, that capitalism is not merely a market economy but a political economy. Its institutional framework is shaped by political choice.” This is where our third metaphor is essential.

After recognizing states and nations for their political economies, even when they are as diminutive as some city-states, the authors’ argument fails to recognize one of the most basic relationships in *all* capitalistic societies—including those within city-states as small as Singapore or Venice. If one misses the point that political and economic systems are distinct yet overlapping clouds, climate change or even a hurricane can be easily overlooked. Capitalism is but one of two interrelated systems of governance, the other being democracy.

Capitalism Incorporates Political Dimensions

It is critical that we all keep in mind the principle that capitalism is a system for the governance of economic relationships; it is not a system for the governance of political relationships. The latter is the role of a political system, which, in the most enduring national examples, is some imperfect form of democracy. Unfortunately, the authors have failed to draw any lines of demarcation between economic and political problem-solving. In addition, they have not recognized that capitalism has a second, micro level of governance within firms. This micro level needs recognition, especially because, since the 1970s, the U.S. has experienced a very significant shift in its second level of capitalist governance from an inclusive or social democratic form of capitalism known as “stakeholder capitalism” to an extractive, oligarchic variety known as “shareholder capitalism” (as I mentioned at the outset of this book review). Whereas stakeholder capitalism recognizes that each society has a variety of classes of stakeholders—including employees, suppliers and communities as well as shareholders—“shareholder capitalism” focuses on an almost exclusive promotion of the interests of shareholders, top managers, and wealthy elites.

This distinction is of crucial importance. Shareholder capitalism is an extractive strategy in which other interests receive the minimum benefits consistent with securing their participation in the system or market—and nothing more than that minimum—as though one were buying the services of the factors of production with much the same rationale as buying normal commodities in any product market. Whereas any capitalist system is likely to lead toward an oligarchy in its political system over a period of decades, an extractive form of capitalism such as the shareholder version is sure to lead to it sooner and in more extreme forms. I see this as a major if not *the* major cause of rising inequality in the U.S. since 1982. On the other hand, Thomas Piketty sees the cause of rising inequality in the capitalist world as largely due to a shift toward a world where rates of return on capital have once again become higher than economic growth rates, and this change in relative rates of growth brings about change much like tides in the ocean (Piketty 2015). There are no specific institutions inducing such a change. Rising inequality in the U.S. is much more likely due to changes in the micro institutions of its capitalism from the inclusive stakeholder model to an extractive shareholder version that favors a wealthy elite at the expense of the bulk of the population. This is a transformational change, one deserving of far more public scrutiny than it has received thus far.

I view this change from stakeholder to shareholder capitalism as one of three “toxic” changes in U.S. capitalism which I endeavored to explain in Chapter 14 of my book (Scott 2011b). An explication of these changes requires a model of

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capitalism based upon human agency, as in the city-state and, emphatically, in neither the “clouds” nor the “clocks.”

A Better Framework

The authors should show readers how to be a literate observer of capitalist governance, an essential background for appraising capitalism’s current challenges as well as future potential. Even though such discussion might take them beyond the formal bounds of sociology (the authors are self-described sociologists), if they choose to write about capitalism, they should accept responsibility for a robust and dynamic definition of capitalism as a system of political economy (i.e., governance), in keeping with their unanimous judgment that it is such a system. Accepting the label means accepting the challenge of definition and at least some analysis of the dynamics of how it operates and evolves through time.

Furthermore, I suggest that they owe readers an explanation of how capitalism relates to the other great system of societal governance, none other than democracy. The late Gabriel Almond, a distinguished professor of political science at Stanford, lit the way for the identification of such definitions and even suggested an analytic framework that might serve as a guide for decades of academic research on how these two systems of governance relate to each other. I paraphrase the gist of Almond’s paper on capitalism and democracy as follows:

Capitalism and democracy are the two leading problem-solving systems of society: capitalism for economic systems and democracy for political systems. Since 1990, capitalism has prevailed in the world, both in practice and theory, with only minor exceptions, in the governance of economic systems, while democracy has prevailed in theory, but much less in practice, when it comes to political systems. These two systems co-exist, overlap, compete for power and transform each other through time. (Almond 1991)

The last sentence suggests an analytic challenge to learn about the essential elements of these two systems, how they relate to one another, and, not least of all, how they evolve through time via a process of mutual transformation as mandated by political processes and, indeed, competition among political actors. Almond’s framework implies that the authors should recognize that many of the key societal threats ostensibly of capitalism actually emanate from flaws in political systems. For instance, the authors imply that Germany post-1870 was a capitalist threat to other societies. Perhaps so, but I believe that German policies under Bismarck and then Kaiser Wilhelm are better analyzed as German policies

for dealing with its fears of encirclement by a Russian-French alliance, where the role of capitalism, though obviously important, was perhaps less than central.

In a similar way, their discussion of the U.S. decision to abandon the Bretton Woods framework in the period of 1971–73 should have been structured differently. Rather than their attribution of this change to U.S. capitalism, I suggest that key decisions were related to the electoral choices facing Lyndon Johnson—i.e., increasing spending for his Great Society Programs and the Vietnam War without raising taxes, which implied increasing public deficits and inflation as inevitable consequences, and a dramatic deterioration in the U.S. balance of payments as well, and thus the need to deflate the economy or devalue the currency—and then to Richard Nixon’s similar unwillingness to face economic reality and raise taxes to finance the continuing war in Vietnam. These decisions indicate that two successive U.S. Presidents were unwilling to accept the so-called “Washington Consensus” remedies for inflation because deflation of an economy was and still is an almost sure way to lose an election. Thus, Nixon’s decision to “float the dollar” was based on short-term electoral considerations far more than on flaws in U.S. capitalism.

The authors point to the need to study capitalism based on an analysis of systems, but they limit such analysis to the notion that “systems begin, operate, and eventually die or disappear.” This is hardly an adequate perspective. A physical system, such as our solar system, has endured for billions of years, with only minimal evolution, whereas any biological system can be expected to continually evolve. Neither of these examples of systemic development is of much help for the student let alone the scholar of capitalism. Capitalism is neither a biological system nor a natural physical system, nor a cloud or clock, but rather a socially-constructed system like a city-state. Students of socially-constructed systems such as city-states or even nations need to learn how such systems can be created and guided—and, indeed, misguided—by human agency through their embrace of faulty ideas, institutions, and policies. Neither capitalism nor democracy is a self-governing system.

Democracy, like capitalism, uses markets in its decision-making processes, but economic and political markets differ in crucial respects. Economic markets need little introduction: they are part of our everyday language and familiar to all of us. However, the markets of democracy are not so easily recognized, even though they, too, are part of everyday experience. Democracies have two quite different types of markets; one is for the selection and election of candidates for political offices, and the second is a market for proposing legislation for possible modification and then adoption by a legislature. While both kinds of markets can bypass the stasis of bureaucratic relationships, and therefore support the “creative destruction” of obsolete institutions, they are nonetheless very different

in how they work. Economic markets can achieve equilibrium of supply and demand through the price mechanism such that the results are more or less mutually beneficial for sellers and buyers. Political markets are often characterized by circumstances where the winner takes all, and where one or both parties are tempted to add unrelated items to achieve additional votes so as to win at the expense of the other parties. The authors do not advise U.S. about any of these characteristics. What are the essential elements of such systems? How do they operate in isolation? How do they relate to each other in the short run? How do they evolve through longer periods of time? How can distortion in one system transform and thereby distort the other? Again, the city-state as a metaphor for the study of systems, focusing explicitly on social systems that involve human intentions as well as differing systems of governance, would have served the authors well.

Explaining Capitalism and its Historical Roots

Despite the title's implication that their book will help us determine whether capitalism has a future, the authors virtually ignore the vast amount of ill-defined research on the history of capitalism. For many authors, capitalism is almost synonymous with the Industrial Revolution; economic growth is explained as a result of the new technologies and the employment of new, inanimate sources of energy, with little to no mention of the existence of market frameworks, let alone of their evolution.

Braudel, writing his three-volume history, *Civilization and Capitalism* (1982), had a similar problem. He included capitalism in his title but almost missed it in his nearly 2,000 page analysis. The central question he proposed was "What was the yeast that led to the rise of Europe?" in the period 1400–1800. How ironic that he did not use the explanatory potential of the concept of capitalism to animate his argument. Although he candidly admitted that he could not define capitalism, he explained that he used the term for want of something better. Unfortunately, his search for a natural ingredient to supply energy and/or animation to his system, such as "yeast," with no explicit role for human agency, (e.g., no institutions such as "recipes for mixing and cooking the ingredients"), meant that Braudel never recognized that part of the answer to his question was in the title of his great book.

What of the evolution of capitalism in geographic and temporal terms? When I researched these questions I came to the conclusion that capitalism was a European creation, as is widely recognized. In my view, it had emerged in Venice, perhaps by the year 1400, and in the United Provinces of the Netherlands from some point in the 1500s. It came to England after the Glorious Revolution (1688–89), which overthrew the Stuart Monarchy. It was not established in France until

well after the French Revolution and came still later to Italy, Portugal, and Spain. It was not established in Asia or anywhere in the southern hemisphere until the second half of the nineteenth century.

In my view, the minimum requirements of a capitalist system are constitutional government, the rule of law, control of the budget by a legislature, a central bank or monetary authority to manage the public debt as a basis for an elastic financial system, and control of enough military and/or police power to have a monopoly of violence in its territory. Braudel had no such definition, but he did recognize that, for capitalism to emerge as a system, feudalism had to be displaced. This displacement required political decisions. Capitalism did not spread easily and silently like a liquid on a flat surface or like product sales in markets. In today's language, its spread was based on a thoroughly political process, where political institutions were transformed or even overturned.

The transformation of the prevailing feudal systems into capitalism was not primarily motivated by a relentless search for private profits, as the authors seem to imply, or by any recognized theory of political economy (Lachmann 2000). Instead, it was created incrementally by powerful elites in response to urgent challenges to deal with the great existential European problem of the era 1400–1800, as I have explained above. Most of the city-states disappeared, including Florence, Genoa, and Antwerp, while the giants, such as Russia, France, and Spain, survived without radical reform. The leaders in the emergence of capitalism were not to be found in either the giant states or the mini-states or in academic communities, but, instead, among political leaders in some of the middle-sized powers that were able to avoid hostile takeover, notably Venice, The Netherlands (and Belgium), and England.

The highly-formalized markets of capitalism depended upon establishment of the rule of law, and this in turn required the overthrow of absolute monarchies—typically with transformation into limited monarchies. As Paddy Ashdown, former leader of Britain's Liberal Democratic Party has written (2006), the great European contributions to societal governance were in the institutions of limited monarchy (and the rule of law), not democracy. Limited monarchy helped build loyalty to the emerging states, enhancing the credibility of monarchs willing to repay their debts. These changes increased the borrowing power of middle-sized states, which, in turn, facilitated their ability to finance the mercenary forces key to avoiding hostile takeovers.

During the formative years for capitalism, the Europeans developed legal institutions that gave structure to capitalism a century or more before they established democracies. Europeans exported slaves and slavery to their colonies during the eighteenth century while enjoying religious freedom and The Enlightenment at home. Yes, the Egyptians had markets before the Christian era

and, doubtless, even the inhabitants of ancient Timbuktu also had them. But the implicit prerequisite to the flowering of either system of governance was that the political system had control of the “guns” or means of coercive power. Having control of the “guns” comes before either limited monarchy or capitalism. None of the African or Asian or Latin American cities or states developed anything approaching capitalism, in the sense that I use this term, as their economic system before the late nineteenth century.

The key idea that enabled capitalism to facilitate growth was not just the essential importance of the rule of law; some notions of law were much more supportive of effective capitalism than others. Capitalism “as we know it” owes one of its crucial pillars to English conceptions of law as opposed to those of the French; the former permitted any activity not specifically forbidden in the law, whereas the latter prohibited any innovations until advocates received permission from a competent political authority. Both the English and French capitalist systems were decentralized, but the economic actors in the English system were free to try anything unless and until prohibited, a situation which still prevails. In contrast, French law, under J. B. Colbert, a chief minister of Louis XIV, established a system in which producers were required to have a permit to change the color of a shirt or the cloth in a pair of pants, with transgressors subject to fines and/or prison. English entrepreneurs were free to innovate, subject to the laws and regulations of their market frameworks. The freedom to innovate was a very important advantage in facilitating the opportunities for Schumpeter’s notion of “creative destruction.” The French system could be expected to induce more standardization and, thus, economies of scale in a Cartesian approach. Needless to say, the English system was gradually adopted by most—though not all—capitalist societies (systems resembling the French approach still exist in parts of Africa).

Capitalism as a system of economic governance owes its origins to some very exceptional circumstances in Venice, beginning in the late fifth century, when some of the successors of Roman civilization took refuge from the marauding tribes of the north to occupy a few tiny dry spots in a lagoon in the Adriatic and then created and/or enlarged the dry spots and/or small islands as their new home (Ginighian et al. 2010). The Venetians were few in number, exposed to attack from other powers along the “Adriatic” (e.g., from Genoa to Istanbul), as well as other, closer “Italian” cities, and were faced with an existential threat for centuries. The inhabitants of what eventually became these small islands grouped around the Rialto banded together to elect a duke to rule them, and then gradually enlarged their domain to that of a small empire that included some of the Greek islands and the Dalmatian coast, and even Istanbul for a time.

Although the Venetians had important salt deposits that helped them achieve some early exports, it is certainly far from clear that the key to their success was in promoting their “comparative advantages” in salt, as the clock-makers might have us believe, so much as in envisioning and then promoting the mobilization of additional resources, such as land and timber, from the mainland to build up additional dry area for its inhabitants, and then developing public systems for water collection and distribution, transportation, waste disposal, and collective defense (i.e., a mercantilist system). One of their crucial governance innovations was forbidding their Duke to pass on his title to an heir; his successor had to be elected. Another, and seemingly dissonant innovation, was to keep voting rights restricted to the inhabitants in the original islands, thereby treating the subsequently annexed territories of “terra firma” as though they were colonies, rendering Venice a constitutionally-ruled empire.

Thus, Venice had almost 1,000 years’ experience in limited monarchy by the time its regime was overthrown by an Austrian army in 1797, and immediately thereafter by the French during the Napoleonic Wars. As Braudel suggests in *Civilization and Capitalism*, Venice enjoyed the highest incomes in the world for perhaps 200 years, from about 1300 until about 1500. This seems utterly remarkable because I do not find any indications that Venice was a society early to embrace the industrial revolution and certainly no indication that it was a practitioner of free trade. Indeed, it was a leader in the development of mercantilism, which was organized trade, designed to enrich their state so it could pay for its own defense. Venice is also credited with the largest manufacturing facility in Europe in its famous Arsenale, a dry-dock, ship-manufacturing facility for hand-built wooden vessels, as well as armaments and ropes which, at its peak, employed about 16,000 people, in what has been described as the first example of a state-sponsored institution for the promotion of industrial development. At its peak, the Arsenale produced ships using one of its canals as the basis of what some observers have called an “assembly line” that was an early version of factory assembly methods later used by Henry Ford. At its best, the Arsenale could complete a new warship every day to support a Venetian fleet (civil and military) estimated at 3,000 vessels.

Venice was also a pioneer in chartering banks and in requiring banks to hold government bonds in their reserves, generating safe incomes with which to pay interest to depositors. As a result, Venice created an elastic supply of money and credit with which to finance growth. With state debt and a limited monarchy, Venice could borrow money for 3–4% while the hegemonic absolute monarchies such as Spain and France were paying three times as much, and often more. Acemoglu and Robinson (2012) say little about the way Venetians transformed difficult circumstances into a situation where they had the resources to avoid

hostile takeover, but they do add something very interesting to the Venetian story when they point out that it had an inclusive notion of citizenship for several hundred years, thus admitting new blood to the ruling group in a city empire and also encouraging competition for positions of power.

Once the access to the ruling groups was frozen to a set of families and their heirs, *la serrata*, a crucial source of dynamism was lost and an important element in its eventual stagnation and decline was added. Even so, Venice escaped the crippling internal coups that afflicted Florence under Savonorola and then the Medicis and external conquest such as the Milanese takeover of Genoa. It remained a limited monarchy and enjoyed centuries of high incomes followed by a generally comfortable decadence.

The acid tests demonstrating capitalism's existence in Venice are 1) the creation of a system of governance based on limited monarchy and the rule of law that provided the framework for raising money at moderate costs ; 2) their development of a financing system based upon bank credit such that Venice could expand its money supply through the creation of credit, represented through paper money, which permitted its government to borrow as needed for defense and justice in return for loyalty and taxes, taxing its trade network to finance its defenses; and 3) it accepted interest on capital as a legitimate form of income, including earning more on capital than its cost for their own society; 4), pioneering the use of double-entry book-keeping; and 5) in having a regulatory system capable of reining in excessive leverage among its banks, as required. In the formative years of capitalism, Venice, the Netherlands, and England could "punch far above their weight" in Europe, whether that weight was measured in population or "GDP," because they could borrow money to hire mercenaries and repay the debts over extended maturities because the interest costs were low.

The Authors Should Recognize and Explain the Importance of Market Frameworks

The historic advantage of capitalism as a system of governance for economic relationships was derived in large measure from its development of market frameworks, as illustrated in the case of Venice. Market frameworks facilitate the efficient use of resources and help to reallocate resources effectively in the face of changing opportunities, as well as changing societal priorities. Capitalism helps a society maintain positive returns to finance political independence, and allows private economic actors freedom to operate within those market frameworks so long as they play by the rules. This is a key point: Capitalism succeeded by embedding *all* of its markets (goods, services and the factors of production) into market frameworks created by political authorities (i.e., frameworks based upon the recognition of appropriate property rights for goods and services produced

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and distributed according to approved contractual trading relationships). Its success was not derived from so-called “free markets,” nor upon some all-consuming desire for unlimited profits by its capitalists. In fact, those two concepts, “free markets” and “unlimited pursuit (and retention of private profits),” seem about equally mistaken in characterizing Venetian capitalism. Centuries of vulnerability to internal and external predators instilled a sense of community in Venice from its earliest times.

The formulation and specification of property rights and a set of laws of contractual relationships through legislative action is the essence of political economy. These frameworks are not permanent, like the Ten Commandments; they can change as a reflection of a system of governance. One can see anecdotal evidence for the importance of these frameworks in the importance most law schools place on introductory classes in Property and Contracts. The crucial role of market frameworks as a hallmark of capitalism implies that any analysis of its present, let alone future, must grapple with the dynamics of political economy. The artificial splitting of political economy into its component parts, roughly its clouds and clocks, may have had many advantages, but it certainly impoverished both areas by all but eliminating the kind of analyses called for by Gabriel Almond’s recognition that these two systems transform each other. It is a relationship routinely underemphasized not to say ignored, by economists, and one which tends to drive political scientists into analyses based upon correlations where the political economist might be able to advance a more compelling analysis based upon causality. The authors of this book make no explicit mention of the evolution of market frameworks, nor of the processes or indeed the societies in which they were first created, nor how those frameworks might have been enforced or to what effect. In practice, capitalism was created through limited monarchies, where the king was also subject to the rule of law. In all the literature of political science with which I am familiar, democracy came later.

Capitalism as a System and its Connections to Political Choices

What do the authors tell U.S. about capitalism as a system, and notably of its connections to political choices? The key paragraph in *Does Capitalism Have a Future?* is this:

Capitalism is not a physical location like a royal palace or financial district to be seized by a revolutionary guard or to be confronted through an idealistic demonstration. Nor is it merely a set of sound policies to be adopted and corrected as prescribed in the business editorials. [Nor is it] the old ideological illustration of many liberals and Marxists that capitalism simply equals wage labor in a market

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economy. Such was the basic belief of the twentieth century, on all sides. We are now dealing with its damaging consequences. Markets and wage labor existed long before capitalism, and social coordination through markets will almost surely exist long afterward. *Capitalism, we contend, is only a particular configuration of markets and state structures where private gain by almost any means is the paramount goal and measure of success.* A different and more satisfying organization of markets and human society may yet become possible. (authors' emphasis; 7)

Although the first five sentences of the foregoing paragraph are broadly true, the sixth sentence, stating that "markets and wage labor existed long before capitalism," is a misleading source of confusion throughout the book. The authors have not recognized the defining role of market frameworks in any capitalist system and the granting of conditional powers to private actors to exercise decentralized powers within these established market frameworks as the crucial factors in defining capitalism as a system of political economy, as well as in recognizing its various "brands." These market frameworks, which grant conditional freedoms to private economic actors to mobilize and govern resources through hierarchical organizations, demand stability in definitions of property and contractual relationships, yet provide flexibility for private actors to meet the exigencies of supply and demand within markets thanks to the pricing mechanism. The essence of the institutional frameworks for capitalism is that they are not a particular configuration of institutions but a changing set which are adjusted through the political process to meet changing conditions, including changing societal priorities.

Failure to identify, let alone explain and evaluate, the role of market frameworks and the grants of conditional powers of governance at the firm level prevents the authors from seeing crucial differences between the pre-capitalist markets of 1500 or so and the much more formalized capitalist markets that come later. Although most of the writing on capitalism by economists and policy makers is guilty of this same mistake, these are egregious oversights in a book of such academic importance as *Does Capitalism Have a Future?*. The book's forecast that social coordination can continue through markets is similarly unfortunate. The "invisible hand" of the pricing mechanism can perform a remarkable feat in coordinating market operations measured in terms of supply and demand for existing goods and services globally as well as locally, but it cannot establish or legitimate property rights or trading relationships anywhere.

This is a key distinction. Capitalism has, thus far, proven a dynamic and successful problem-solving system for economic relationships within a political economy. Its success derives from the way that sovereign governments allow

and/or motivate economic actors, whether individuals or firms, to exercise conditional freedoms to develop, produce, market, and distribute various goods, services, and factors of production within the political jurisdiction controlled by that government. Most U.S. definitions of capitalism stress the role of private property while virtually ignoring the role of market frameworks. In doing so, these definitions miss the fact that the conditionality of capitalist systems (prior permission is or is not required before making an entrepreneurial change) is a function of their market frameworks. More importantly, the most successful examples of these frameworks are based, for the most part, upon the ingenious idea that any behavior is permitted so long as it is not explicitly prohibited. The force behind this definition and the subsequent enforcement of these conditions is none other than the political legitimacy and force of government.

Market frameworks inevitably have a characteristic “policy slant,” favoring some interests relative to others. This is notably true for so-called *laissez-faire* capitalism as well. *Laissez-faire* favors the rich and the powerful; they can reinvest their earnings to increase their relative lead in wealth and power over time. Although the notion of a “level playing field” is the familiar mantra for the trading relationships of capitalism, this phrase is greatly overworked—as though it were a near universal norm. In reality, most—if not all—capitalist systems tilt the rights to participate in the system either toward inclusiveness and a relatively egalitarian distribution of the fruits of the system, with backing by broad political consent, or toward unequal participation in a system oriented to the extraction of benefits from the bulk of society for the benefit of an elite few backed by the political force of the state, as suggested by Acemoglu and Robinson (2012). These two models tend to be labelled as social democracy for the former and as oligarchy—and some measure of political repression—for the latter. These two models imply differences in the macro perspective of capitalism managed through the central political authority and also at the micro level through the empowerment of the key economic actors, the firms. Thus, although Thomas Piketty sees the cause of rising inequality in rates of return growing more rapidly than GDP, the view espoused in this review sees a key source of inequalities in capitalism in the structuring of institutions that set the context for the key economic actors, i.e., the key units of production and distribution, the firms themselves. A *laissez-faire* version of capitalism is sure to end up inducing oligarchy, as it has been doing for a second time in the U.S. since about 1980.

Protecting Private Actors from Abuse by One Another and the State

The institutions of capitalism and democracy must protect private actors from abuse by one another as well as from possible abuse by the state. Because most capitalist systems allow key economic actors (e.g., firms) to mobilize and control

resources through hierarchies, capitalism inherently creates a context in which private parties can exercise power over one another and potentially abuse one another in the course of the productive process. Democratic societies, to be faithful to their mandates from society, must find ways to limit abuses of power within the private sector, just as they must find ways to limit abuses of power exercised through the visible hands of government agents, a point which seems to have totally escaped Milton Friedman in his influential book *Capitalism and Freedom* (1962). In my view, the spread of the ideology of shareholder capitalism amounts to the empowerment of shareholders, hedge funds, and the like to abuse the largely unprotected rights of other stakeholders in the firm. Business school faculty have been egregious offenders of social democratic ethics in accepting such a logic in U.S. capitalism, as though it were perfectly acceptable for U.S. firms, as though they were not sensitive to the notion that this was legitimating an amoral version of capitalism.

I believe the U.S. Supreme Court made a similar mistake in its 1905 decision in the *Lochner v. New York* case. After the Civil War, the U.S. Supreme Court was guided by the idea that the Constitution had mandated that U.S. capitalism must be *laissez-faire*, meaning that no laws or court decisions should have any policy tilt toward one class of participants or another. The Court adopted the idea that *laissez-faire* outcomes were the product of a *natural system*, like that of Darwinian evolution in biological systems; unregulated markets sprang from a “natural” system, rather than one created by a legislative process, and therefore carry a policy tilt by societal intent. To call market outcomes “natural” is not only mistaken because a *laissez-faire* regime cannot exist without political approval, but it is also based upon an intellectual swindle because *laissez-faire* relentlessly favors the rich over the poor and, thus, can covertly maintain and enlarge inequalities in the system.

It should not be a surprise if the rich tend to see the results of *laissez faire* capitalism as “natural” because the system systematically favors their interests through a regime of restricted regulatory powers. Free markets lead inevitably toward progressively more unequal incomes, which is purportedly Darwinian and therefore a “natural” outcome. By this logic, a monopoly is a natural outcome; indeed, nothing is more indicative of free markets than abusive monopolies because their emergence indicates “freedom from interference.” In the *Lochner* case, the Supreme Court struck down a New York statute that forbid New York bakeries from expecting their workers to work more than 10 hours per day, six days per week, in spite of the fact that the Supreme Court of New York had affirmed the right of the legislature to limit contractually recognized hours as in the interests of the good health of the labor force. In *Lochner*, the Court said to place a limit on working hours would deprive workers of the “freedom” to work

still more hours if they were willing to contract to do so. Any such regulation of hours of work would inevitably tilt the distribution of income away from its natural level, according to the decision, favoring the labor force relative to the bakery by restricting the supply of labor, which amounted to an illegitimate interference with the “natural result” of market forces. Setting a law for maximum hours in bakeries might or might not be poor policy, but “certainly it was not unconstitutional.”

In my view, however, the real issue in the *Lochner* decision was revealed by Justice Oliver Wendell Holmes in his dissenting opinion. In his view, “a constitution is not intended to embody a particular economic theory, whether of paternalism and the organic relation of the citizen or of *laissez-faire*. It is made for people of fundamentally differing views, and the accident of our finding certain opinions natural and familiar or novel and even shocking ought not to conclude our judgment upon the question whether statutes embodying them conflict with the Constitution of the United States.” Justice Holmes recognized that the model or “brand” of capitalism was one for political contestation, where the Supreme Court should stick to the role of referee and not allow itself to take a legislative role, let alone one where its views were superior to those of a legislature.

The *Lochner* case illustrates that the authors of *Does Capitalism Have a Future?* have ignored the way that governments exercise power through parliaments and regulatory agencies; the legitimacy for control is not to be found in the pages of the “business journals” to which the authors refer. The authors clearly disagree with the choices that governments have made, but the fact remains that governmental choices define the rules of engagement both for the private and public sectors—for better or worse. The authors also err when they talk about markets existing well before the advent of capitalism. It is my contention that, in so doing, they have missed a key pillar of capitalism, which is the promulgation and increasing formalization of the institutional frameworks for those markets. The issue is not one of goods passing through markets, but of having formal market frameworks that specify what property rights are or are not recognized in the markets and what contractual rights are or are not allowed.

The markets of capitalism have very little in common with roadside markets in the Third World or grey markets, let alone black markets in the First World. To think otherwise is an oversight of capital proportions, yet one the authors share with many economists. Capitalism is a system of governance based upon formalized property rights and trading relationships enforced by regulatory agencies and, ultimately, the courts, as well as one of allowing prices to operate freely within those markets—hence, it is indeed a system of political economy and not just of the economics of markets. The invisible hand can coordinate

supply and demand through the pricing mechanism, even on a global basis, but it does not and indeed should not be permitted to govern property rights or trading relationships.

Simply put, to begin to develop approaches to avoid the future economic calamity foreseen by the authors, it is imperative that they start by recognizing that capitalism is not a self-governing system. The misconception that capitalism is governed by an invisible hand is at the root of many of the all too familiar, yet serious, misunderstandings of the nature of capitalism. Those who see the invisible hand as the key to markets fail to see that capitalist markets are rooted in the political economy of market frameworks and not just in the economics of markets or, more superficially, in the coordination of supply and demand; their analysis fails to recognize the political roots of the system let alone the nature of the transactions involved. The missing roots are market frameworks, including the chartering of economic actors, without which there can be no capitalist markets. The alternative is not free markets, but chaos, as we found out in 2008.

But just what are these so-called political roots, these market frameworks, and how can they be missing? I believe we can find an acceptable analogy in the world of organized sports with tennis as an example. Tennis can be played in formalized, organized competition, as at Wimbledon or a set of tennis courts almost anywhere in the world. In any of these circumstances, multiple competitions can occur through any number of games or tournaments, but an essential feature of these contests is that all are played in similar circumstances, i.e., similar “market frameworks.” The players are allowed to compete in “free markets” in the sense that they can attempt to hit the ball with their tennis racket in their right hand or left, or even two-handed if they wish. But they all use tennis balls, and, to make valid shots, the ball must stay within a framework: the court is divided into a forecourt and backcourt, with a net in the middle; the service must clear the net and land in the opponent’s forecourt without touching that net; and no more than two attempts may be made on any point. The players can compete technologically by choosing their own tennis racket, but they cannot play with a larger or smaller ball, or one that has been “deflated.” To observe that such twenty first century organized competition in tennis is nothing new by simply comparing it to the lawn tennis formerly played by the landed nobility of English society results in rather dramatic oversimplification that obscures what capitalism is about instead of clarifying it. Whereas such informal lawn tennis might or might not have a codified set of rules, this much older form of “market-based” competition would hardly require more than a few simple rules, and not likely a referee at all. However, when Andy Murray takes on the likes of Roger Federer on one of the courts at Wimbledon, there must be a platoon of referees

and, more recently, instant replay to allow technological measurement of whether a shot was or was not within the lines.

This formalization of markets for both modern competitive sports and for capitalist markets has entailed a crucial set of innovations. When it comes to capitalism, the property which is being developed or traded must be accurately defined and identified and the permissible trading relationships spelled out in a code of laws and regulations, i.e., market frameworks. In addition, the laws recognize the rights of private parties to create legal vehicles called firms or corporations that can be granted certain rights to operate in these markets, including the right to hire and fire people, to establish the terms of their employment and compensation, to raise capital from passive investors in differing amounts or shares, and to survive indefinitely, even as the founding individuals leave the corporation (in contrast to a partnership, which might have to be reorganized). In addition, corporations can be granted limited liability in the event of default or bankruptcy and protection against the demands of shareholders to redeem their shares, e.g., in the U.S., only a Board of Directors can decide to distribute funds to shareholders, either through repurchase of shares or as dividends in their favor. The crucial innovations that constitute capitalism are built upon the idea there can be no property without law and no law with government; this logic can be extended to the axiom, “there can be no markets without market frameworks, no market frameworks without property and contracts, and no property or contracts without law and no law without government,” a proposition which Harvard Law professor Cass Sunstein attributes to Jeremy Bentham. Hence, capitalism is indeed political economy and not just a response to the economics of markets.

Whereas corporate charters might be used to limit the scope and/or duration of a license to operate, for example to build and operate a bridge or a road, general purpose charters for corporations have gradually become the norm. As a result, we must ask: 1) Did firms have to accept any obligations in return for such grants of power? 2) What rules governed the firm’s use of power and the distribution of any revenues over and above those needed to pay its various suppliers? 3) Were corporations restricted in how they could remunerate and/or discipline employees?

In the United Kingdom, as in England earlier, those property rights and trading relationships were spelled out through Acts of Parliament, not in the pages of “sporting magazines” or their equivalents in business or finance, as the authors suggest. Furthermore, in the twentieth century, governments also began to influence employment in terms of safety and perhaps of minimum levels of compensation.

I would assert, however, that many analysts, and most of the public, seem to have forgotten that a firm or corporation operates under a grant of power from a political authority, normally a state. The shareholder protections based upon “limited liability” come from the state, not from the Board of Directors. The differences in “ownership” based upon shareholding, on the one hand, and the grant of power to mobilize and utilize resources within a society based on the grant of a charter from the state, are fundamental to capitalism, but little recognized, let alone understood, in the U.S.

Market frameworks are not much discussed in the literature of economics, political science or history (e.g., by Fernand Braudel). Of course, legal studies have been much more concerned with frameworks for property rights, but, for most people, this connection between the law and markets is a very difficult one to fathom, for want of any way to envision a market framework. What does it mean to say that a “market framework” is spelled out in a set of laws and regulations? How can such a framework be visualized? Capitalism is typically embedded in frameworks that have few, if any, physical boundaries, except when it comes to the zoning of real property, but the possibilities for formal legal rules far outrun those even within the most formalized sports, of which U.S. professional football might be the iconic example.

Can an Organized Team Sport Help Us Deepen Our Understanding of Capitalism?

First, we should note that organized sports cannot provide a perfect analog for capitalism—but the contrasts with sports can also be illuminating. Most sporting contests promote entertainment. If the scores are kept, they are wiped clean at the end of a season, thereby equalizing starting conditions among competitors each season, promoting “fair” competition to see which competitor is superior in each particular season. Other elements are shifted routinely, for example, as teams change ends of the court or the field after a particular time period, just to ensure parity of context.

Not so with capitalism. Normally, capitalist scores earned in one season carry forward into the next in terms of differing resources under a firm's control. And the competitors can have radically different sizes in terms of employment as well as differing financial resources. Sporting competition is normally “for sport,” whereas capitalist competition is “for keeps.” A level playing field is assumed to guarantee fair competition. However, the lobbying in capitalism is intended to tilt market frameworks to favor one set of interests over others. Thus, far less temptation to modify the market frameworks exists in sports than in capitalism, simply because sporting competitors change ends of the court or field on a regular basis. Promoting unfair advantages is an accepted part of capitalism, even

an accepted area of specialization, e.g., as a lobbyist. It has been one of the dependable growth areas in employment and incomes that seems least threatened by foreign competition.

Where the familiar language of business is allegedly built around a desire to have a “level playing field,” it is only rarely a preferred position. Much of the lobbying in capitalism is based on hiring expert help to modify market frameworks for the long term advantage of special interests, i.e., to deliberately create a playing field that is tilted in favor of one or more competitors or special interests relative to the others. Activities which would be considered blatant cheating in organized sports often seem to fall within the norms of active lobbying in the U.S. Indeed, lobbyists occupy such an important part of U.S. capitalism that they seem to overwhelm the federal government in Washington, D.C., where fertile grounds for lobbying have been ploughed and tended for years. Having such firms attempting to influence the system is increasingly common, and the existence of incentive compensation in capitalism is likely to encourage the borderline behavior commonly called “gaming the system” that could easily deteriorate into outright breaking of the rules.

A Failure to Address the Unique Characteristics of Individual Capitalist Systems

The authors failed to consider that each capitalist system has unique characteristics—because each has a different governing authority. For instance, the U.S. and Canada have a common frontier of approximately 3,000 miles, with free trade in goods, services, labor, and capital; nevertheless, this openness does not result in a single, North American version of capitalism. Indeed, why didn't Canada experience a financial crisis in 2008—none of *its* banks went broke or had to be bailed out. Although several reasons exist for the banks' ability to remain afloat, three stand out for their clarity as well as importance. Canada has six big domestic banks, which stretch from coast to coast. These banks could reallocate their funds geographically without resorting to derivative securities. Each bank could keep responsibility for collecting its domestic loans, so there was less of a temptation to use derivatives and the increased leverage that they permit (and, indeed, tend to induce). But second, their banking authority was simply unwilling to permit the increases in leverage allowed by U.S. banking authorities. Third, and perhaps most fundamental of all, Canada has its own political system distinct from the U.S. variant that does not permit either firms or labor unions to make political contributions to political candidates prior to elections.

Although such analysis would only begin to unveil the complex differences between the two countries, the authors do not even take such small steps. They do not mention the uniqueness of any political system as impacting financial

policy, nor do they mention how various “brands” or varieties of capitalism could be transformed by their political counterparts, let alone how they might be reformed.

The reason for this oversight harkens back to the major weakness in the authors’ discussion: they cannot postulate reform of contemporary capitalist systems without understanding that reform would require the approval of one or more political authorities in the system. Thus, another crucial element in understanding most brands of contemporary capitalism is understanding its relationship with the brand of democracy practiced in the state (or community of states) in question. For example, in a recent discussion, Canadian authorities were emphatic in explaining the rather obvious point (to me as an outsider) that their system did not allow the lobbying or large financial contributions permitted in the U.S. As a result, it was less open to corruption than the better known system to the south.

The Authors Should Recognize the Current Anti-Social and Corrupt Nature of U.S. Capitalism

I believe the authors need to give specific recognition to flaws in the U.S. version of capitalism, first because U.S. capitalism is indeed the “elephant in the room” and second because U.S. capitalism has become remarkably more corrupt and anti-social since an inflection point in the 1970s similar to one the authors choose to emphasize with unfavorable reference to the more democratic U.S. experience of the 1950s and 1960s. Some of the flaws in U.S. capitalism are attributable to flaws in U.S. democracy, which makes the task of reform more challenging and, at the same time, more important. It also suggests that some of the misfortunes which they anticipate over the next few decades have already happened, yet have not been fully recognized.

The authors have rightly identified some major flaws in current practices of capitalism, such as undercharging for pollution and inadequate provision for common resources (e.g., clean water, biodiversity). In addition, they have challenged the notion that capitalism will inevitably generate enough new jobs to replace those eliminated through globalization and technological change. Some observers still profess to believe that to doubt these propositions is to be a Luddite. However, I believe that the authors are correct in warning that the past historical record is no proof of the universal validity of such relationships. It is time for the development of a theory of how they will work in the face of radically different circumstances, such as the advent of robots and the digital economy, a point which they make quite effectively so far as I am concerned.

At the same time, I also believe the authors should have reviewed the relative distributions of income by country as an important indicator of how capitalism

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and democracy influence each other. For instance, income distribution in France and the U.S. remained broadly similar from 1945 until 1980, after which the U.S. pulled away to achieve the highest share of incomes for its wealthy among the democracies of the traditional Western world. Does this indicate a possible threat either to or from U.S. capitalism or democracy—or perhaps both? Should there be a concern that roughly 90% of the income growth in the U.S. since 2009 has gone to the top 1%?

The Distinction of U.S. Governance of its Capitalism and Democracy Relative to the Other Western Countries

Each country enjoys some degree of sovereignty over its own affairs, but, in reality, some countries might have their sovereignty much more or less concentrated in a few institutions than others. For instance, most Western democracies are parliamentary systems, where sovereignty rests in the legislature, often in the lower house. The prime minister acts as chief executive, but his or her power is derived from representing a majority in the legislature and not necessarily one in the electorate. In contrast, the U.S. has a presidential system, where sovereignty is split between its three branches. Thus, Congress has the legal power to declare war while the President is commander-in-chief once war has been declared, and the President has a national electorate which he or she represents independently of any particular state electorate.

While I believe all countries have some form of control over the zoning of real property, wide, important differences exist. Thus, England and France each have a “federal” office of zoning that permits a certain measure of national control over local zoning issues and a provincial office at an intermediate level. In contrast, the U.S. has no equivalent in federal zoning, and most states have little or no zoning control. As a result, most U.S. zoning is by cities and towns, and, until the 1930s, local governments spent more each year than state and federal governments combined, except in time of war. The relative roles of public and private sectors has changed radically since the coming of railroad and then the truck, and still more since the 1930s. Whereas local zoning authorities had roughly equal powers with merchants before the revolution in transport, giant merchants such as Walmart and Amazon dwarf the powers of any local regulatory authority. Thus, in reality, the U.S. has allowed its zoning to be taken over by private interests relative to those which represent the public, a situation which is evident when one sees the respective patterns of land usage in England and France on one hand and the U.S. on the other.

However, when it comes to exercising power over political and economic systems, the U.S. Supreme Court has powers that, to the best of my knowledge, have no close parallel in any other Western democracy. Although courts no doubt

exercise some influence over market frameworks in many countries because they continually make case-specific decisions, one of the most crucial of the U.S. Supreme Court's powers does not descend directly from the Constitution, but instead from an early Court decision which set a precedent not explicitly provided for in the founding document or subsequent amendments. That power is judicial review of decisions by the other two branches, as asserted by the Court in 1803 in the case of *Marbury vs. Madison*.

In *Marbury*, the Court decided unanimously that James Madison, the newly designated Secretary of State of the Jefferson Administration, need not award a commission for a minor federal office to Marbury because the official award of papers for that office had not been "served" to Marbury while the Adams administration was still in power. Thus, although Thomas Jefferson had reason to challenge this expansion of power by an unelected Court, he did not do so. One can suppose that Jefferson's passivity in this situation stemmed, in considerable measure, from the fact that if he objected, the particular case would have favored an additional appointment for a person loyal to the Adams regime, which Jefferson detested.

The power of judicial review was not explicitly stated in the U.S. Constitution but was debated as a concept by the framers and in the *Federalist Papers*, no doubt because some form of review had been practiced in several colonies, reflecting a tradition within British and American law (Hamilton, 1788). Within a judicial system, a court decision could be made by a simple majority, but what did it mean to have judicial review of a case when there were contrasting views of public laws? When deciding issues of public law where the opposing parties involved government agencies, or even branches of government, a court decision might be much like a constitutional amendment, shifting power from one agency to another, or even one branch of government to another. Specifically, was it appropriate to decide such issues by a simple majority on the Court if one side involved the two Houses of the Congress and the Supreme Court was the other side?

Although the Supreme Court used the power of judicial review only twice from 1790 until 1860, it invoked this power 58 times during the next 70 years, or until 1930 (Horwitz, 1977). To my mind, the problem with judicial review did not surface with *Marbury*, where the Court was unanimous, but rather with respect to cases in which a 5-4 vote could overturn an Act of Congress. In Congress, of course, overturning an Act often requires a majority in each house and a supermajority in the Senate.

More troubling is the trend that has developed gradually since the Civil War, in which 5-4 Court decisions have become a major force shaping U.S. market frameworks, political as well as economic. The issue is not so much the propriety

of the review but the idea that a simple majority was adequate to overturn an act of Congress. This circumstance took on special import after the Civil War because the Republicans occupied the White House 75% of the time from 1860 until 1932, resulting in a Court which generally had a conservative majority.. In this context, it became more common for the Court to take on a political role, helping to decide on the “strike zone,” as well as calling balls and strikes (to borrow the language of the current Chief Justice, John Roberts).

Some of the most contentious Supreme Court decisions have been rendered by 5–4 majorities, such as the Citizens United case, which allowed nearly unlimited political contributions by large donors. As a result, the U.S. political system has institutions whose powers and missions have been influenced by a simple majority of nine unelected justices. To the best of my knowledge, none of the other North Atlantic democracies has any such powers under the control of an unelected body. Although Australia does seem to have similar powers of judicial review, it is my understanding that their justices do not represent similar partisan politicization. I point to this issue, again, to observe that a careful look into the role of an unelected Supreme Court is something that merits the attention of such senior authors as the team that wrote this book.

Judicial review by simple majority has been pivotal in establishing the rights of organizations to make political contributions as though they were equivalent to political “speech,” and therefore protected by the same Constitutional rights as natural persons. Thus, the Supreme Court has played a critical role in opening the U.S. political system up to increased influence by money and the potential for greatly increased corruption. This is a particularly striking example of the way in which the transformation of a legal institution in a capitalist system can increase the political power of the wealthy, the relative power of the wealthy to re-shape U.S. capitalism, and, in the end, the power to reshape U.S. democracy as well.

I am afraid that the analytic framework chosen by these authors, (i.e., macro-sociology) gives U.S. little intellectual purchase on such issues, yet they are arguably of crucial importance to the future of capitalism. Fareed Zakaria (2007) reminded U.S. that Woodrow Wilson went to Versailles in 1919 to see if he could help “make the world safe for democracy.” It seems to me that I might revise the question to ask whether U.S. capitalism and indeed its democracy are still safe for the world? It is a question which might appropriately be asked of or better yet by the authors of this book.

Have US Capitalism and Democracy Lost their Way?

To gain some perspective on the crucial questions of the impact of the U.S. elephant on the global systems of governance we need to take account of how U.S. governance has changed, and notably since the 1970s.

US capitalism and democracy have been radically transformed since 1970 and so has the distribution of income. In *Capitalism*, I traced two distinctive periods of the mutual transformation of U.S. capitalism and democracy, one from 1830 until 1937 and the second from 1965 until 2009. In each case, I followed the evolution of U.S. capitalism and democracy from an inclusive, egalitarian system governed through principles that can justifiably be labelled as social democratic to a system that became extractive and oligarchic. Despite broad similarities in the two transformation periods, the specific forces and specific changes in the various systems were quite different.

The first of these periods saw the appearance of giant firms, with the largest 10 companies growing in employment by more than 10,000%, and doubtless, the firms grew still more in terms of incomes, assets, and economic power, surpassing even the largest state governments in terms of economic power. In the most recent transformation period, the large firms continued to grow, but their powers were dwarfed by those of the federal government. Progressively, however, the U.S. witnessed a huge shift in power away from the federal government and into the hands of private interests, notably the financial services and pharmaceutical sectors. These changes occurred thanks to a greatly expanded role for markets and a popular belief that markets could be largely self-regulating, accompanied by a greatly depreciated perception of the proper role for government.

The transformation of U.S. governance in the 1970s had numerous causes. While it is impossible to adequately review them in this space, two crises must be mentioned. The first was the so-called Watergate breakdown of governance in the White House, which had a very dramatic, unanticipated, long term influence on U.S. democratic governance. The second was a crisis in U.S. macroeconomic imbalances that caused rising inflation, recurring budget and balance-of-payments problems, and abandonment of a fixed rate of exchange for the dollar. These imbalances were met by a remarkable tightening of credit by the Federal Reserve in 1980, which led, in turn, to a quite unintended crisis in U.S. capitalism from 1981 onward, with changes that have neither been fully appreciated nor adequately addressed.

With respect to the crisis in democracy, the U.S. government enjoyed remarkable public support during World War II and the 1950s, in spite of very high taxes on personal incomes (up to 90%), a costly war in Korea, and failure to deal with segregation or the limited rights of women and minorities. However, a long period of declining support set in during the late 1960s, a decline attributable to tensions over the extension of civil rights legislation and the assassination of a president in addition to gradual U.S. involvement in the Vietnam War, all set in a context where rising incomes seemed to be a dependable

regularity, drastically reducing the perceived needs to pay heed to employment, productivity, and incomes. They were taken more or less for granted.

Whereas the tensions over civil rights were initially centered in the South, they spread across the country by 1968; a number of major U.S. cities suffered significant experiences with civilian violence, and the Democratic Party experienced an intraparty revolt at its national convention in Chicago, where Hubert Humphrey was nominated to succeed a sitting president who chose not to run again. Humphrey won the nomination following the assassination of Robert Kennedy without competing in any of the open primaries. As a result, he was dubbed the candidate of closed party meetings of paunchy white men meeting in smoke filled back rooms. Party activists rioted, and the Chicago police were called upon to quell the riots with tear gas. Meanwhile, the tensions over Vietnam resulted in publication of secret Pentagon Papers that made the reality on the ground (in Vietnam) appear much worse than the impressions made by official assessments or the mainstream press. An attempt at recovery of those papers through illegal entry by burglars with quasi-official direction and backing from White House personnel culminated in the Watergate scandal. Nixon's forced resignation to avoid conviction by the Senate and the indictment, conviction, and jailing of 25 members of his administration was viewed by some as vindication of the constitutional system (Gergen 2000). However inelegant, this process was a success in cleansing the executive branch.

However, in the aftermath of these sordid developments during a Republican administration and a tumultuous Democratic Party nominating process, a Democratic Congress viewed the scandal as an illustration of the weaknesses of a system that embodied an excessive concentration of power in the hierarchy that needed decentralization and increased transparency in the nomination process and within Congress as well. In this view, the U.S. needed to be more subject to government by the people, (as though government more nearly "by the people" would automatically be more "for the people," in Lincoln's famous framing of the issues). These ideas were part of the adoption of markets as a panacea for America's problems of democracy, and deregulation was the remedy to get there.

In the aftermath of the impeachment, the governance of both Houses was changed, dramatically reducing the powers of the leadership and opening the legislative process to the filing of bills by any member. Whereas Congress had been led, if not exactly governed, by about 30 senior members representing the two parties, it was "democratized" so that any member could introduce a new piece of legislation. At the same time, most members were given access to staff help, albeit not in equal amounts, and almost all official business had to be transacted in open sessions, where the press and lobbyists could view the process (Mann & Ornstein 2006, 2012).

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In this new regime, more than 500 members of Congress could introduce legislation, in effect becoming “legislative entrepreneurs.” The legislative calendar and the workweek were shortened; these changes dramatically changed the culture of Congress. In the eyes of Mann and Ornstein (2006), “(before these changes) successive classes of freshmen (House and Senate members) would come in and prepare to take office, their incredible pride at...being part of history as an exclusive and small group of people ever to have served, was palpable...(but after the change in culture) by the 1990s, that...pride gave way to skepticism...new and returning members increasingly saw their job in Congress...as an unpleasant duty.” Members no longer had time to get to know one another because the value of moving families to Washington was reduced and the normal types of interaction (through carpooling, or informal weekend activities) declined. In the new, “democratic” atmosphere, the hierarchy had less power over the members, as did the party machinery. How could the newly liberated legislative entrepreneurs mobilize power? The most obvious answer was by mobilizing more money and lobbyist support, and allowing “markets” to decide—in this case, political markets. In the end, American faith in “free markets” effectively put Congress up for sale, a process which has continued and even been enhanced since then. But such concerns were set aside in a context where deregulation became a panacea in the political realm as well as the economic.

The Toxic Spiral of Special Interests

The authors should have considered whether the long term corruption of market frameworks helps special interests amass power to such an extent that the U.S. has experienced a toxic spiral in its political processes since the early 1970s.

In appraising how these changes to Congress’s structure and operations transformed the quality of U.S. democracy and capitalism, consider our tennis court analogy. Congressional entrepreneurs now work with their supporters to reshape the courts to fit the circumstances and even the aspirations of their constituencies. Congressional representatives can continually offer to try to reshape the “legislative court,” knowing that capitalist players do not ordinarily change sides of the court. The possibility to assist political supporters by reshaping the court for the advantage of their particular industries or regions presents never-ending possibilities for legislative entrepreneurship for the benefit of special interests, paid for by consumers and tax payers. It is like Congress hanging out a sign: “Open for Business; Bring your check book.”

This democratization of Congress has also provided a smooth route to a more and more “extractive” brand of capitalism and democracy, and, in reality, to governance by an increasingly rich oligarchy. Excessive focus on “government by

the people” has not led to government more nearly for the people but instead into government for a rich elite and to increasingly recurrent instances of near chaos, as indicated by the continuing spate of financial crises.

Or consider another major event, the decision by the Federal Reserve under Chairman Paul Volcker to rein in the inflation of the late 1970s. Once the 1980 election was over, Volcker presided over a tightening of credit to the point that 10-year treasury bonds were yielding 16%; shorter-term maturities yielded even more. Although inflation would descend from about 9% to more normal levels, and eventually to a much more successful 3%, the unintended consequences included a severe recession that began in 1981 and a major decline in the prices of common stocks. Indeed, it caused the prices of stocks to decline from record high P/E ratios of 30 in the late 1960s to levels in the teens in the 1970s and to less than eight in the early 1980s. At this nadir, common stocks were selling at less than 50% of book value (and, for several years, at about 40%). All of a sudden, the stock market ceased to be a major avenue for financing growth and instead became an arena for financing takeovers and bust-ups.

Investment banking became the prime source of earnings for the major Wall Street firms. Indeed, if they could acquire a commercial bank, they could have access to the insured deposits of the latter and thus to resources to finance takeovers. Once in control, these firms could cut employment, reduce research and development, sell surplus assets, and refloat the “carcass” on the market. Firms that did not voluntarily reduce their assets and employment along these lines risked hostile takeovers, with management almost assured that it would be reduced in size and cost. Traditional corporate norms of long term employment and mutual loyalties of firm and employees became anachronisms. Opportunistic management with little or no concern for past employee contributions to the firm replaced the old model of management. Massive incentive compensation was offered for raising shareholder earnings but primarily available only to the most senior of executives. The cloud-like sociology of shared responsibilities and trust, as well as the accumulated skills of loyal employees, were replaced by the clock-like mathematics of financial economics with their one-way, upside incentive structure.

The force of this demotion of the sociology of management by the economic calculus of maximizing short term profits drove a transformation from stakeholder capitalism to the new shareholder capitalism. New managers could act with the ruthlessness of mercenaries, where the academic blessings of “shareholder capitalism” in the interests of a narrow elite led to little loyalty to any interests other than their own: As they acted more and more like mercenaries, America’s top managers could count on the official blessings of its leaders in business education. After all, they were following the teachings of

Milton Friedman in his famous book, *Capitalism and Freedom*, and the newer writings of Michael Jensen on the need to guide firms toward the most important goal of maximizing share prices (e.g., Jensen and Mechling 1976). It was a self-reinforcing system in which the pursuit of short term profits was alleged to be to the advantage of American society and an extreme example of the overwhelming power of the clock metaphor that had taken over business school curricula and all but merged the teaching of economics and business. These circumstance were brilliantly captured by the late Sumantra Ghoshal (2005) in an article for the Academy of Management that was aptly titled, "Bad Management Theories are Destroying Good Management Practices." As he summarizes, "by propagating ideologically-inspired amoral theories, business schools have actively freed their students from any sense of moral responsibility." The bad management theories were none other than those of shareholder capitalism, supported by the bad theories of financial economics that substituted its clock-like theories for the sociology of stakeholder capitalism still practiced in most other countries.

Implicitly, this trend had impeccable academic credentials. Two major foundations, Carnegie and Ford, sponsored major studies of U.S. business education in 1958–59, and both were sharply critical of American business schools for not emphasizing traditional forms of academic research, instead substituting less rigorous case studies in which faculty tried to learn from practitioners. Although much of the case-based research on firms was indeed superficial, when carefully done, it represented first rate microsociology on the origins and development of firms, a process like some on the development of city-states. The Carnegie and Ford studies heralded the triumph of academic snobbery in presuming that academic economists knew far more than mere business people about managing business as well as the triumph of economics (notably, financial economics) of Michael Jensen over sociology and political science. It was also spiced with general contempt for managers who believed in building long term value into their firms; i.e., it focused on the interests and perspectives of hedge fund managers and other short term traders, with little if any concern for the interests of society. Managers who focused on longer term objectives were wasting shareholder funds. Financial economics was the center of this new paradigm; it was all based on clock-like metaphors, with top-down logic that favored increased rewards for the rich so they could have earnings parallel to their shareholders.

In shareholder capitalism, corporate strategies focused on stock prices as the supreme measure of value. This put U.S. firms on a different playing field than many of their European counterparts. Whereas Europeans paid CEOs 20–30 times their average employees after World War II, and U.S. firms 30–40 times, the Europeans gradually crept up toward former U.S. levels while the U.S. levels rose

to an unparalleled 400–500 times the average employee salary (Scott 2011b). Compensation consulting firms advised boards of directors that U.S. top managers should be paid like shareholders so they could act from shared interests. This led to a cult of senior managers, all paid in the same way, no matter what business results they achieved, which became the center of a U.S. capitalist oligarchy. They reassured each other that extracting more and more “take” was best for all while economists in business schools and elsewhere assured them that they should maximize a single variable, share price, to avoid any ambiguity in their objectives.

Michael Jensen became a leading exponent of these views, replacing the former leadership of the now-deceased Milton Friedman. The academy became a leading source of bad ideas on management, sponsored by people who had little if any knowledge of the microsociology of securing cooperation in a fast-changing world (Ghoshal 2005). It was a bonanza for superficial theories anchored in calculating earnings per share. As price-earnings ratios again rose to roughly 30 from less than 8, a dollar of earnings was worth almost four times as much, just for average performance, thanks to rising earnings after twenty years of declining interest rates. In reality, it was the market that was performing more than the firms. When market setbacks came, as they inevitably did, the markets came to count on the Federal Reserve to loosen credit and bring interest rates down another notch, eventually to about 3% on ten-year Treasuries. As regulator-in-chief, Alan Greenspan saw these developments as testimony to the success of U.S. capitalism and the rewards of a “great moderation.” When pessimists tried to advise him of a market bubble, he refused to accept that he or indeed any regulator could know more than the markets.

Where Does Shareholder Capitalism Stand Today?

Consider the following evidence from a recent prize-winning article in the *Harvard Business Review* by Professor William Lazonick of the University of Massachusetts at Lowell. According to Professor Lazonick, “...the 449 companies in the S&P 500 index that were publicly listed from 2003 until 2012 used 54% of their earnings—a total of \$2.4 trillion—to buy back their own stock” and “another 37% to pay dividends,” leaving about 9% for other purposes, including new investments or higher incomes and bonuses for employees other than top managers (Lazonick 2014). Companies were reducing their investments in the real economy in order to pay more to their executives. What was happening?

Consider this. Lazonick goes on: “In 2012 the 500 highest paid executives (named in proxy statements) received on average \$30.3 million each, with 83% of that amount in stock and stock options.” Stock buybacks were helping sustain not to say increasing the stock prices and, thus, the wealth of the richest people in

those firms while depriving everyone else from additional chances to work for a company with more to spend on research, added investments in capacity, new activities, and/or pay raises. It was the epitome of an extractive strategy to take incomes and capital resources away from almost all interests to transfer them to shareholders and top managers, who were paid like shareholders.

Were these events just due to the play of so-called market forces? Not quite. One of the key institutional changes facilitating this new, extractive strategy was a ruling from the Securities and Exchange Commission that firms could repurchase their own stock at times and in amounts of their own choosing. The SEC, the nominal guardian of investor interests, had become a facilitator for this more extractive form of U.S. capitalism that was not good for employees, for firms, or for the country. Its only beneficiaries were to be found on Wall Street and in corporate board rooms. Professor Lazonick's explanation is much like the one in this review (or perhaps my explanation is much like his): Since the late 1970s, U.S. capitalism has switched from a governance oriented "retain and reinvest" strategy that increases the capabilities of employees who helped make the firms more competitive and more stable in terms of employment to one based on "value extraction" for the benefit of those at the top. Thus, a huge change in the practices of U.S. capitalism has already occurred, and the authors all but overlooked it. It affects all of America, and there is no end in sight.

Consider another example of the seriousness of the problem. Under the extractive strategies of shareholder capitalism, the average incomes in the top 0.1% of the U.S. population have been driven by stock-based pay, and, since 2012, the top 0.1% of incomes have reached 11.3% of GDP compared to 11.5% in 1929. So, since the early 1980s, the U.S. has managed to return to an extractive strategy like the one it had in the 1920s that presaged the Great Crash, one in which its top executives are making roughly 300 times the compensation of their average employees, a gap that is roughly 10 times that of many European countries.

Deregulation, Shareholder Capitalism, and Incentive Compensation for Executives

Deregulation, shareholder capitalism and incentive compensation for executives were keys to changing market frameworks to extract value from society for the benefit of the rich. When deregulation was launched in the 1960s, it was a way to increase exit and entry of firms, as well as to provide increased flexibility in the offering of capacity (e.g., in transportation), to make pricing more flexible and therefore competitive. By the 1980s, the meaning had been broadened, especially in the labor and financial markets. One of the key changes in the financial market frameworks came in 1982, when the SEC instituted Rule 10b-18, under which a firm's board of directors was allowed to authorize it to repurchase its own shares

at times and in amounts as chosen by the firm, provided they do not exceed certain daily amounts related to previous daily amounts traded. Because the ruling does not require the firms to report daily purchases, the regulatory authorities have no records of such purchases unless they launch a special investigation. This change came under the chairmanship of John Shad, a Reagan appointee and former vice chairman of E. F. Hutton, a mid-size Wall Street firm. His reasoning was that stock buybacks would help the markets channel savings more efficiently and that any manipulation that might go undetected did not justify onerous disclosure requirements for companies (Lazonick 2014).

The Notion of a Firm as a Legal Person

The notion of a firm as a legal person seems more like part of a cover-up for an extractive strategy to benefit oligarchs than part of a legal system to help create governance for the people. Under U.S. law, firms qualify for treatment as “legal persons” and, as a result, have been given rights to free speech as though they were natural persons. Any effort to limit political contributions has been curtailed as though it interfered with free speech as guaranteed by the Constitution. This has been secured through decisions of the Supreme Court, beginning in 1976 (e.g., *Buckley v Valeo*, 424 U.S. 1, 1976).

What have we done, and still more, why? Shareholders—and their firms—have the protection of limited liability that individuals do not have. Firms are also entitled to raise funds in unlimited amounts, which they can retain indefinitely, in a legal form that can live indefinitely without periodic re-chartering. Investors can sell their shares, but they cannot reclaim their funds from the firm unless the Board of Directors declares a dividend or authorizes a share buyback—again, protections not available to individuals.

Is this an appropriate balancing of rights and responsibilities? Most firms are governed by their Boards and, in U.S. capitalism, to be managed for their shareholders as their rightful owners. But what are the responsibilities of firms in shareholder capitalism? In many European countries, firms are recognized as having responsibilities to society, i.e., the “stakeholders” that have granted them their powers. A similar notion of stakeholder capitalism prevailed in the U.S. until the 1970s, but shareholder capitalism replaced it as share prices trended lower in the wake of ultra-high interest rates resulting from the Federal Reserve’s decision, first, to constrain credit, and, then, to gradually loosen it. With firms selling at 40%–50% of book value, the stock markets functioned like used car lots at best—and chop shops at worst. So-called “investors” could buy control and act as ruthlessly as mercenaries, all with the blessings of the finance gurus of the academic community. Americans switched to shareholder capitalism in the belief that firms were “owned” by their shareholders, and, therefore, any residual

income properly belonged to them. Firms were given charters by the various states, but all they owed to society was to obey the laws and pay their taxes. Milton Friedman and others advised them that to consider any social responsibilities beyond those explicitly mandated by law as akin to giving away the shareholders' money, rather than being socially responsible members of society. As he declared, "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible" (Friedman 2002).

Where does ownership come from, and what responsibilities does it implicitly carry? In U.S. capitalism, the competition among states to offer charters with minimal societal obligations led to a "race to the bottom" in setting those conditions. Delaware has played an important role among U.S. states in recent decades, though, in the nineteenth century, New Jersey took the lead in minimizing conditionality within the U.S. Because many other countries have a single source for such charters, and, quite understandably, demand that firms accept responsibilities to various stakeholders, the differences in ideas on corporate governance between the U.S. and other countries somewhat parallels differences between countries that are profit sanctuaries. Market frameworks create critical disparities; over time, the wealthy, with economic power, can pressure governments to widen those disparities by granting the powerful even more lenient terms to take more from the system in return for leaving less for the benefit of less powerful and/or less mobile contributors, for instance, by transferring more and more of their income to foreign subsidiaries to reduce prospective U.S. income tax liabilities.

Is the U.S. "Elephant" a Safe Model for the World?

Since 1980, U.S. capitalism has been shaped by incentive compensation for senior executives and shareholder capitalism, all buttressed by the notion that a corporation should be treated as a legal person; yet, corporations are protected by limited liability, a right that ordinary individuals do not have. Americans have lost sight of the reality that a corporation is an artificial legal construct and not a person at all. By accepting this illusion, we have also ignored key institutional changes that devolve more power to markets under the intellectual guise that markets create a natural system, and therefore are fair by definition.

Nothing could be further from the truth. These changes in U.S. capitalism have steadily pushed the U.S. toward favoring the interests of an increasingly wealthy oligarchy. "Trickle-down economics" was an intellectual swindle wrapped in another swindle: that markets are a natural system, with results therefore beyond question. We must recognize that a particular set of political choices

impacting the governance of U.S. capitalism, has gradually favored the interests of the top 1–2% of the population. These choices are consistent with oligarchic, “the elite take all” values and inconsistent with the values of social democratic governance.

The interconnected transformations of the two systems of governance have led to a continuing degradation of democratic values and practices in both systems, as Gabriel Almond’s analysis forewarned they might. Once we recognize where we are heading, we should also call for reform through appropriate actions by the Congress. But a Congress so beholden to wealthy interests is unlikely to vote for reforms that “hurt” those interests.

Some Illustrations of a Model for Reform

Reform is possible, and deserves attention, though I can do no more than hint at the prospects in this paper. The U.S. pharmaceutical industry provides a model of a partial remedy for U.S. capitalism in the way it accepted a requirement of prior approval for new drugs as though it were a cabinet-maker seeking a license from the French regime of Louis XIV. Under this regulation, the U.S. drug industry has become a world leader in taking preventive action in the public interest. First, a proposed new drug must be shown to be safe to the satisfaction of the Food and Drug Administration, and, second, it must be shown to offer potential therapeutic benefit before it can be sold on the market. This anomalous U.S. system was lucky to be ahead of Europe when thalidomide came out in the late 1950s and the FDA refused to authorize it for use by pregnant women. Europe, including Germany and the UK, did authorize it, and, as a result, experienced many cases of children born with birth defects. As a consequence, Europe changed to require pre-authorization for new drugs, and then extended this approach to all chemicals. Thus, Europe has been even more aggressive than the U.S. in trying to protect its public from harmful new products by requiring a special authorization.

Because of this success, I suggest that a similar model could be considered for financial services. In this hypothetical model, no financial “products” could be traded on exchanges unless they could be shown to be safe for the financial system—and of potential benefit for the public. This would immediately imply the need to “stress test” under what conditions derivative securities were both safe and beneficial to society as opposed to firms using derivatives to bet on future values of other firms as if they were regulated by Las Vegas instead of by the SEC. The model would also challenge the circumstances that permit ultra-high velocity trading based on algorithms. And, no doubt, it should also eliminate rules permitting firms to repurchase their own shares, except under rigorously restricted circumstances. The model should also prohibit incentive compensation, including grants of stock or stock options, for executives in financial institutions

that have publicly-insured deposits. So long as such incentives start from a perspective of micro-management of firms, executives will be tempted to take risks to “game the regulatory system” for their own advantage, as they have with stock buybacks, even at great risk to society.

Sounding the Alarm

It's not enough to sound the alarm unless we can clarify just how deeply ingrained the problems are. Given the enormity of the problems capitalist societies face, I applaud the authors' courage in beginning to ask some difficult questions. As they recognize, capitalism is a system of political economy, which means that we must use the framework of political economy to build a new, more dynamic, societal or stakeholder-oriented model of capitalism. Because the primary economic actors are firms, that model must start from something like stakeholder capitalism.

Even though the authors have performed a service in recognizing that the roots of capitalism lie in political economy, they have done little to help analysts, including those in the academic community, to recognize that its roots lie in its market frameworks. Those market frameworks are created by legislatures and administered by regulatory agencies. This means that they lie in institutions which are not governed by the famous invisible hand. In fact, they are dependent on effective actions by the visible hands of government personnel. They demand case-based knowledge of how firms operate, which lies primarily in macro-sociology, and not in the teaching of the new financial economics. In some ways, the prevailing academic models have obscured the public's understanding of this fact. Pushed to logical extremes, I believe the siren song of quantitative modeling will continue to tempt scholars to overdose on mathematical models, as though such models were the essence of true science, and ignore the implications of such modelling.

We must start at the beginning and agree that capitalism cannot be self-governing. Left to its own devices, capitalism degenerates into a laissez-faire system that will turn a democracy into an oppressive oligarchy through a relentless increase in the inequalities of income, wealth, and economic power, as it did in the U.S. beginning in the 1880s and repeating in the 1980s.

Unfortunately, the academic failure to develop and popularize a dynamic model of capitalism, including its overlapping coexistence with democracy, has created a major challenge for future research and policy analysis. Case studies where economic actors, such as regulators and business executives, have a chance to contribute their practical experience will be essential to stay focused on developing a better understanding of reality as a counterweight to academic temptations to transform reality so that it can be more conveniently modeled.

In short, I call for:

- The social scientists in the academic community, economics and political science faculty in particular, to accept a large measure of responsibility for failing to articulate an adequate, multi-disciplinary concept or definition of capitalism as a very important platform for future research and policy development. *It should start from the premise that laissez-faire capitalism is incompatible with democracy.* Over time, lightly or corruptly regulated capitalism is a sure recipe for the relentless accumulation of resources in the hands of the rich. The money to buy the legislature will allow this process to move more quickly and to greater distortions, like the U.S. authorization to repurchase shares.
- That same community of scholars (including the authors of this book) should focus research on the way that capitalism and democracy transform each other over time. That community should include senior business practitioners. Nothing short of case-based, multi-disciplinary research will be adequate to this challenge. , and the target should be one or more theories of how the competitive interplay of capitalism and democracy can transform each other, indefinitely. The goal of that research should be one or more theories of how these societal constructs can and should develop to meet changing circumstances, including changing societal priorities.
- Schools of government should commit to teach about government *for* the people, not just *by* the people.
- Business schools should commit to teaching about stakeholder capitalism as generally preferable to shareholder capitalism, since the latter is a thinly disguised version of teaching how mercenaries are servants of the societies on which they prey.
- Law schools should teach about the ethical responsibilities of lawyers toward society and not just toward clients. They should teach about the appropriate balance between the use of the law to empower firms and to regulate them and lawyers' ethical obligations to their respective societies as well as to their clients.

Conclusion

The authors set out to warn their readers of a coming worldwide crisis in the practice of capitalism. I believe that the foregoing analysis shows that such a crisis has already begun and is advancing. It can be summarized in three sets of great, institutional changes. (1) The promotion of markets as a panacea for the governance of both capitalism and democracy since the 1970s. Deregulation of those very markets has conflated government by the people with government for

the people in the reforms of democracy. (2) The transformation of guiding principles for the management of firms from inclusive forms of stakeholder capitalism in favor of progressively more extractive versions of shareholder capitalism., including the repurchase of their own shares beginning in 1982. This shift has focused on the interests of the top 10% or even less of the population. (3) Greatly increased usage of incentive compensation for top executives and traders in financial markets, as though it were both necessary and appropriate to have one-sided incentives (up-sided only) in order for such people to serve the organizations that they nominally serve and/or lead.

These three great changes have been led by none other than “the elephant in the room,” the U.S. capitalist system and, especially, its sponsors, the business community, which has secured greatly decreased taxation on their personal incomes and the inheritances they pass on to their heirs with reduced responsibilities for the accuracy and or appropriateness of the advice they give to their clients and customers. Furthermore, U.S. firms have income inequalities which are by far the highest in the developed world. The world model, both for capitalism and democracy, is one characterized by the extraction of revenues and wealth from middle class folks, supported by no-tax pledges by political candidates who recognize that their electorate does not have the education to understand that they are being victimized by their alleged representatives. The future is, in all likelihood, more of the same, thanks to a corrupt system facilitated by that renowned pillar of U.S. democracy, the Supreme Court. The authors were right to ask the question they did.

Now, I believe we should all call for the beginning of a new era of examination of capitalism in all higher institutions of learning. The authors might start with a look at whether the criticism that Sumantra Ghoshal made regarding “amoral theories” of management is accurate. Perhaps the answer lies in understanding that other disciplines must be invited to weigh in on the question of management education, notably including history and micro-sociology, to try to study how to develop a broader sense of responsibility in our universities. Most important, the prevailing theories, such as shareholder capitalism, must be examined under a new, more powerful moral lens that includes the recognition of the systemic role of capitalism as a political economy—and the ongoing tug of war between capitalism and democracy that has been the foundation for much of the economic growth and success enjoyed by the world. For that reason, the academic community should take the first step in re-examining the realities of capitalism to re-invigorate it with a moral dimension, based on the fact that a corporate charter comes from society and not the shareholders or the Board of Directors, and, with a multi-disciplinary approach, find a new foundation for the study of management.

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