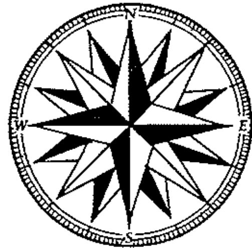

Book Reviews

Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity, by William J. Baumol, Robert E. Litan, and Carl J. Schramm. New Haven, Conn.: Yale University Press, 2007, 336 pages, $30.00 hardcover; ISBN 978-0-300-10941-2

Reviewed by Denis Collins

The United States is the wealthiest nation in the history of the world. Adjacent to its southern border is Mexico, one of the poorest nations in the world. Why such a difference in wealth?

Is the United States' unique global standing the result of luck, divine providence, personality and talents of those born there, national culture, geography, natural resources, educational system, or political system?

None of these, declare the authors of *Good Capitalism, Bad Capitalism*, though some of those factors certainly help. The primary reason is the United States' unique blend of entrepreneurial capitalism and large-firm capitalism. Entrepreneurial capitalism provides any individual with the freedom to create just about any product or service. Large-firm capitalism provides a mechanism by which new product and service innovations are brought to a global market at affordable prices. The earth is one big continuous improvement economy machine and entrepreneurs grease the wheels.

The co-authors of this relatively easy to read book argue that any nation can grow its economy through entrepreneurship. There is nothing unique about American creativity that can't be found among groups of Europeans, Asians, Africans, or Latinos.

The authors, William Baumol, Robert Litan and Carl Schramm, are institutional economists associated with the Kauffman Foundation, which encourages entrepreneurship throughout the world. The foundation was established by Ewing Kauffman, the billionaire philanthropist who began life as a bed-ridden farm boy and started

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a pharmaceutical company in the basement of his home. When Kauffman sold his business forty years later, it had annual sales of nearly $1 billion and employed more than 3,000 people, ten percent of whom became millionaires. Kauffman and his businesses generated more wealth than many nations.

The book length argument is that: (1) economic growth matters, (2) capitalism enhances economic growth more than other forms of economic arrangements, (3) the combination of entrepreneurial and large-firm capitalism generates more economic growth than state-guided, or oligarchic, capitalism, and (4) any nation can do this.

The "good" in the title "Good Capitalism" refers to mastering a technique, not moral perfection, similar to being a good tennis player or baseball team. Capitalism is good because it generates economic growth. Living in an expanding economy is more enjoyable—there are more jobs and disposable income available—than living in a contracting economy. Some poor people in the United States have cell phones, whereas the poor in Africa and India die of starvation.

Economic growth matters and it matters a great deal. Over the past 200 years industrialized society has doubled life expectancy, eliminated famine, and developed a non-ending list of technological goodies, such as electricity, movies, television, computers, the internet, and iPods. Purchasing power has increased ten-fold during the most recent century and, as the authors point out, if that is difficult to appreciate then imagine balancing your budget with only 10 percent of your salary. The authors note a few major warts, such as pollution and economic inequality, and then set them aside for others to grapple with.

For all this, we have innovative entrepreneurs to thank. The authors appreciate all entrepreneurs, but they have a preference for innovative entrepreneurs—those who create foundational new things, over replicative entrepreneurs—those who create new businesses that provide products and services developed by someone else.

It may seem like common sense that a nation overflowing with innovative entrepreneurs would generate a substantial amount of ever-increasing national wealth. However, the authors are butting heads with other strongly held beliefs about what drives economic growth and constrains human ingenuity. Four competing hypotheses suggest that economic growth is a function of:

H1: Climate, geography and culture
H2: Macroeconomic policies such as more free trade and tax incentives
H3: Property rights and low corruption
H4: Worker skills and education

Of these hypotheses, the most off-target is the first one. Oppressively hot climates, barren geographies, and cultures that encourage conformity may restrict economic growth, but put an innovative entrepreneur in the middle of the Sahara desert and he or she will find a way to get rich by fulfilling some unmet need. People raised

in all cultures succeed in the United States. They would also succeed in their own nations, if their governments supported, rather than suppressed, their creativity.

The last three hypotheses—tax systems, property rights, and education help—are very important contributors to economic growth. But, they are merely accessories. What these hypotheses miss is the individual who transforms social problems, waste, and unmet needs into tangible products and services. If one were to apply the 80/20 rule—where 20 percent of operations generate 80 percent of the revenue, Baumol, Litan and Schramm focus on what matters most—innovative entrepreneurship.

East German citizens took matters into their own hands on November 9, 1989 by smashing the Berlin Wall, the pounding heard around the world. Dictatorial communism and dictatorial socialism did not deliver the goods. Common people longed for democratic capitalism. Private ownership of property won out over centralized elites believing that they knew what was best for everyone.

Capitalism is not a monolithic entity. There are "good" and "bad" forms of capitalism, with the former resulting in greater economic growth than the latter. The authors analyze four different types of capitalism and the impact each has on economic group. Some countries have multiple types.

The worst form of capitalism is *oligarchic capitalism*, where market needs are met by several companies owned by a few wealthy individuals or families, as found in many Latin American nations, former Soviet republics, most of the Middle East, and much of Africa. Governments adopting this model grant economic freedom to already prominent individuals, but not all citizens, and these individuals enhance their own wealth, and that of their family members and friends, at the expense of others. People with a head start in economic life are given the means to further solidify their advantage. This has led to tremendous inequality and corruption.

A second type of bad capitalism that, though well-intended, has not matched the economic growth of the United States, is the *state-guided capitalism* found in Europe, Japan, India, and China. Governments adopting this model support particular industries, rather than individuals or families, that are likely to be economic winners. Companies in these anointed industries are given special bank privileges, tax breaks, licensing rights, and research and development benefits.

A priori, this makes sense. Support the probable winners and ignore the probable losers. But the world does not operate on such a simple model. Industries and companies that should be winners lose, and those that should be losers win. The future is simply too unpredictable and complex.

Large firm capitalism, found in Japan and Europe, as well as the United States, does a better job of generating economic wealth than oligarchic and state-owned capitalism. In the capitalist Olympics, large firm capitalism earns a bronze medal.

Giant corporations achieve economies of scale that reduce prices to an affordable level and more efficiently reach a wider network of consumers. That's the good news. Now the bad news: Although ownership is dispersed among many stockholders, those who manage large firms tend to become more controlling, destroying the creative

freedom that entrepreneurs need to succeed. Large corporations place a premium on job security, rather than innovation, and are pretty good at replicating previous successes and making incremental improvements. Innovative entrepreneurs, for the most part, avoid corporations because the freedom they need to think independently and fail is anathema to many large firms focused on control mechanisms.

The silver medal in the capitalist Olympics goes to *entrepreneurial capitalism*, which is found in the United States, as well as Taiwan, Ireland, Israel, the United Kingdom, India, and China. The leading actors are small innovative companies that quickly respond to market needs. Entrepreneurs take major risks and, when successful, receive tremendous economic rewards. This creates economic inequality, but even those at the bottom of the economic ladder benefit from innovative products and services.

Entrepreneurial capitalist societies share four common features. First, governments make it relatively easy for entrepreneurs to start a business, grow a business, and abandon a failed business. Registering a business is simple and inexpensive, owners have bankruptcy protection, and access to finance is decentralized.

Second, governments strictly enforce property and contract rights. Governmen patents protect innovative entrepreneurs against competitors. Years of sunk cost associated with research and development can be recovered.

Third, governments focus on incentives that foster new ideas rather than way: to limit economic inequality through redistribution of wealth. Some entrepreneur: innovate solely for the sheer joy of doing so, some innovate solely for the money and many innovate for both reasons. This is a lesson some communist nations (i.e. Cuba and North Korea) have yet to learn despite the collapse of the Berlin Wall.

Fourth, governments encourage innovative entrepreneurism by enforcing anti- trust laws and encouraging free trade and global competition. As nations grow theii economies, more of their citizens can afford to purchase imports.

And the gold medal goes to—governments that encourage both entrepreneurial and large-firm capitalism. The former innovates and the latter effectively markets the innovation. Like yin and yang, they are complementary and interdependent.

The authors are institutional economists, not ethicists or social scientists. Pollution externalities and economic inequality are too quickly ignored. The book also contains a host of assertions and ethical assumptions that could serve as fodder for classroom discussion. These questions include:

- Is the quality of life better in the hectic U.S. or indigenous societies?
- Does the United States' environmental problems outweigh the benefits of economic growth?
- Does a growing economy reduce the likelihood of war?
- Is income inequality an uncontrollable outcome of capitalism?
- Can China continue to grow its economic pie without democracy?
- What about Scandinavia?

So how does a Latin American or African nation, where most people barely survive on less than $2 a day, go from no growth or slow growth to fast growth? According to the authors, political leaders within these nations should maximize the distribution of private property rights and put in place the drivers that fuel entrepreneurial capitalism. The political leaders do not have to put anything in place to foster large-firm capitalism. Many entrepreneurial firms, by nature, will grow into them.

What should be the attitude of American business leaders when international businesses located in other nations threaten their markets? They should welcome their success because the more other nations grow their economies, the more likely their citizens will be able to afford American products and services.

And may these businesses be led by ethical people who will do something about, rather than ignore, the income inequality and environmental problems associated with all forms of capitalism, even the gold medal winner.