

Preface

This preface is a story of how this research was conceived and executed, false leads and all. For those who wish to move directly to an organized and logical introduction to my explanation of the origins and evolution of capitalism without this history, I suggest you skip this Preface and turn directly to the Introduction in Chap. 1.

This book began, some 20 years ago, as a study of comparative economic strategies. Initially, I was hoping to identify and evaluate the economic strategies of countries in terms of how they were defined (if at all), how they were implemented, and how well they had performed through time. In 1990, as at the present time, there was no recognized notion of country strategies; indeed there were high-status economists who said that such an idea was a complete misunderstanding of economics. Hopefully, the new *Varieties of Capitalism* literature will help broaden the perspective of those who have held the view that economics presents a universal, context-free, “consensus” model for development, which has little if any need for the visible hand of government in formulating or implementing an economic strategy.

Then, as now, there was no generally accepted definition of capitalism, and most authors seemed content with the notion that capitalism was what firms did in markets; a concept based on the study of firms and product markets, with little or no recognition of the special role occupied by factor markets (for land, labor, finance capital, or the chartering of firms) and still less recognition of the political economy of governance. Lacking such a definition after about 150 years of usage, it is not surprising that there was little consensus on where or when capitalism had originated or how it might have evolved. Some approaches to the study of capitalism found its origins to be coextensive with the development of trade, and thus with multiple geographic locations in pre-Columbian times. A second view, and arguably a very influential one among US economists, was that capitalism is a self-regulating system based upon voluntary transactions among consenting adults. This view, which has drawn little benefit of any historical perspective, is perhaps best exemplified by Milton Friedman and the Chicago School. A third view made capitalism almost coextensive with the Industrial Revolution, a view which equated capitalism with technological progress but which, like the other two, gave little or no attention to governance.

However, as I began my research these differences and indeed any problems in the literature on capitalism were not apparent to me; I was not planning to research capitalism and was unaware whether it could be an operational concept with a clear meaning. This preface is an account of the evolution of the research focus of this book from its inception, when I was preoccupied with the economic strategies of countries, to its final formulation, as an original account of the origins and evolution of capitalism based upon an original definition of the term as an indirect, three-level system of governance for economic systems.

The scope and purpose of the research underwent a profound change after a fortuitous trip to China. This preface is a recollection of some of the milestones in that research journey. As I did not keep much by way of notes on the process, it is a retrospective and necessarily incomplete and only approximate account.

My original plan had been to use the familiar business concept of economic strategy as a research tool to explore and interpret the activities of countries, rather than firms. I defined a national economic strategy as how a government, either directly or indirectly, influenced the mobilization and allocation of the resources of a society in order to enhance its prospects for growth and development, as a parallel to the experience of firms with their strategies. I settled on this topic and research approach for three reasons: first, strategy was the research framework that I had learned at Harvard Business School, starting in the General Management Area in 1959; second, it was a framework that I had used for approximately 30 years for research and teaching, including in an elective course called Economic Strategies of Nations; and, third, as the research was underway a new literature was just appearing that has since come to be known as Varieties of Capitalism. It gave external recognition to the idea that all societies or countries have strategies, however implicit or misguided those strategies might be. In the language of this book, the institutions and policies adopted by a country tilted its markets to favor certain segments of its economy or certain societal groups or purposes over others, and that tilt inevitably amounted to an implicit strategy. The notion that there was no such tilt was highly unlikely anywhere, but even if achieved it too would be a strategy. It was not a natural situation. Thus, my starting point was the belief that the formalities of neo-classical economics, with their emphasis on economic coordination through the impersonal price mechanism, without the visible hand of political governance, was not an adequate framework for understanding economic development anywhere, a viewpoint that would take great support from the work of Douglass North from 1993 onward, as discussed in Chap. 2.

In 1994, when I was about 4 years and 10 chapters into a book on economic strategies and how they influenced economic performance, a chance event led to a radical change in my research plans: I decided to travel to China, where my brother Douglas was stationed as the first Resident Representative of the International Monetary Fund, in Beijing. Given the nature of the opportunity provided by such a trip, I thought it best to stop what I was doing and assemble and explore a considerable reading list on the history of Chinese economic and political development. My wife Grenelle joined me both on the year-long background reading and on the month-long visit. Once in China we were very fortunate to have the help

and guidance of Robert Chen, a Chinese-American entrepreneur and participant in Harvard Business School's Owner/President Management Program, with an operation in Shanghai and another in Los Altos, California. Bob became our guide as well as interpreter for 5 days in the Shanghai-Wuxi region. In the course of our discussions with mayors, deputy governors, and managers of firms, it became clear that the Chinese had quite a different variety of capitalism from the familiar US variety. Most obviously, Chinese government officials at the provincial as well as township and village levels were very much involved in the formulation and implementation of strategies. The Chinese were picking experienced scientists and engineers to be governors and mayors, after having first asked them to manage firms. While the Chinese had opened their markets significantly, their remarkable growth progress was not based on American-style free markets. There were unmistakable signs of top-down management by people who had the energy, the skills, and the power to change the course of events, e.g., the "visible hands" to implement an economic strategy. The notion that the Chinese miracle was powered by the opening of the markets, as in the neo-classical paradigm, was at best a half-truth.

After the trip and the readings, one book stood out for its influence on my thinking: Fernand Braudel's three-volume *History of Civilization and Capitalism, 15th Century to the 18th Century*. In the third volume, Braudel noted something that was completely new to me, to wit that average incomes circa 1500 were relatively equal across the most settled areas of the world at the time, which I took to mean Japan, China, India, present-day Turkey and Iraq, and Europe. The spread between the high- and low-income areas was estimated to be about two-to-one. Yet by the time I was doing my reading in Braudel, that spread had broadened to approximately thirty-to-one because of growth in the high incomes. This increased spread in relative incomes and therefore economic performance raised some immediate questions; for instance, what was it that had led to the rise of Europe, in relative terms, from circa 1500 onward? In hindsight it seems supremely ironic that Braudel was never able to ask if what he was searching for might have been hidden right in front of him, in the title of his book, i.e., in the European creation and adoption of an early concept of capitalism as a system of governance for many, but by no means all of their respective economies. Braudel was never able to define capitalism, as he readily admitted in his second volume, and, perhaps as a consequence, he never considered the possibility that the key to the relative rise of European incomes might have lain in the creation of that capitalist model of governance.¹ Indeed, Braudel did not go looking for a model of governance; instead, he seems to have been looking for some natural force or forces that would explain the relative progress of Europe. What, he asked, was the "yeast" that led to the rise of Europe, circa 1400–1800?

From my vantage point, the rise of England, the Netherlands, Portugal, and Venice could be explained in terms of the strategies that I was looking for: all had adopted mercantilist strategies of economic development by the 18th century, and

¹See Fernand Braudel, *Civilization and Capitalism, 15th–18th Century*, trans. Siân Reynolds, vol. 2, *The Wheels of Commerce* (Berkeley: University of California Press, 1982), 231.

in the case of Venice much earlier. Most of my early chapters were case histories on the early development of these societies, e.g., in the 17th century, which served as building blocks for a theory of purposive growth led by economic strategies. The idea was to use the notion of their respective strategies to explain the inequalities. However, Braudel's search for a single ingredient, a leavening agent, and his failure to find it led me to reexamine my own search for an explanation of economic growth and prosperity in the economic strategies of ascendant and prosperous societies. I began to think that a much more complex interactive process of mobilizing and allocating resources would have been required to give rise to the prosperity of these societies.

After visiting China, the puzzle of its decline, between 1400 and 1800, and the period of Europe's rise, was on my mind. Braudel and others had pointed out that China had occupied a position of arguable economic leadership circa 1400, only to fall to virtual last place by 1800, where it remained for more than 150 years. How could China have fallen behind and remained a laggard? This puzzle was all the more interesting because China had the largest population and by far the largest home market, thanks to an unparalleled inland system of waterborne transport through some 30,000 miles of canals. In addition, it had an advanced form of bureaucracy, and a stock of technologies, which, though perhaps not the match of Europe, nonetheless had many successful exemplars of its own, and was far more sophisticated than any society in the Western Hemisphere or Australasia. And yet Europe, North America, and Australia would pull ahead of China and remain ahead for centuries.

Strategy hardly seemed a promising way to understand what the Chinese had created and then apparently lost. It similarly seemed a weak way to try to explain events in India, Japan, and the Ottoman Empire. These great Asian civilizations had been relatively safe from foreign takeover and thus had little need for an effective strategy until confronted by European colonialism in the 17th century. Was it just coincidence that each of these empires was characterized by highly centralized government with rigid bureaucratic controls that stifled innovation? Was it relevant that many of their advantages, including technological advantages, were monopolized by those at the top of their societies and thus of little benefit to the bulk of their populations? For instance, where Europeans were quick to utilize clocks to permit more efficient use of time by the residents of their cities, Chinese emperors were able to enjoy near-monopolies of the time keeping technologies for their astronomy and astrology, at the expense of their own people. Still more to the point, *why* had it happened? Maybe competition and even adversity could be advantageous or even essential conditions, for inducing the effective mobilization of human energy and motivation as well as more tangible resources. Was external competitive pressure an important precondition for effective strategy and/or governance, as it seemed to be in the case of the leading European states? Was it missing virtually everywhere else at the time?

The relative economic decline of a number of the major economic powers in the period 1400–1800 challenged the adequacy of my research framework and led me to return to the history texts that I had encountered as an undergraduate at Swarthmore

College in the 1950s. In so doing I rediscovered writings on the great European advantages that I had encountered in a course in Modern European History with Professor Mary Albertson: those readings pointed to “good government” based on limited monarchy (i.e., not democracy), the Enlightenment (or the resort to human reason as the ultimate source of authority), and continuous competition among a number of states of relatively similar size, rather than the top-down *dirigisme* of the lead powers of the time, whether France or Spain. However, the survival of the smaller powers depended upon the British policy of maintaining a balance of power: Britain acted like an antitrust enforcement authority. These analyses, however, shared Braudel’s weakness of having little by way of operational models to explain how countries or empires either managed or mismanaged their development.

These issues of societal development were simply too broad for me to analyze until I began to think of two countries, Italy and the United States, each of which hosted two distinctly different regions, with the northern region emerging as the more developed. Why, in both of these examples, had the north of a country done much better than the south, and for more than a century at a time? Research Associate Jamie Matthews worked with me to create two case studies on Italy, one for the period prior to 1980, and one from the 1980s on, to study the effects of patron–client relationships, and especially in the southern or Mezzogiorno region. She then drafted a companion case study of the US post-Reconstruction (1870), which looked at the history of a segregated South in a democratic society, and its comparable experience with the distortions caused by the patron–client relationships of racial segregation.

These cases, exemplars of an idea the Chinese had called “one country-two systems,” shifted my focus toward politically defined regional governance and, inevitably, to the importance of political structures and governance. All countries had regions and regional differences; what was special about these particular regional examples? For one thing, they demonstrated that governance systems did not spread their influence gradually, like trade. A state or regional boundary could demarcate a distinct political system for centuries, free-trade and free-capital movements to the contrary notwithstanding. China was a case in point; it retained quasi-feudal property rights until 1978 and even beyond, a system the French had abandoned in their Revolution 200 years earlier, in a shift that opened the way for capitalism in a land known for its top-down *dirigisme*.

It was at about this stage that Braudel’s metaphor of a yeast-like ingredient leading to the “rise” of Europe fell apart for me. Braudel had related Europe’s advantages to the growth of cities and towns ahead of many other areas; in his metaphor, the cities were not just the high-income areas in Europe but a key source of growth; their roads and markets were like the yeast that allowed Europe as a whole to rise to take the lead in economic growth. However, Jamie’s search of historical records showed that the Ottoman Empire had larger cities than any in Europe (e.g., Istanbul), and China had larger cities still. Cities were where growth took place, but were they the principal causes of that growth?

Cities could grow on the basis of tax revenues collected as a result of compulsory payments to central governments. These tax payments might accrue in their national

capitals, as rising per capita incomes for civil servants and others, in which case they were a reflection of the use of wealth and not its generation. Alternatively, a city's wealth could be derived from revenues generated by trade, for example, in seaports such as Istanbul or Venice.² Only growth from the latter would be indicative of new wealth that might promote further growth. While Italy had the highest incomes from 1400 to 1700, that wealth was concentrated in mostly modest-sized cities, in the north and center, and was attributable mostly to trade. Cities themselves could induce growth, but they did not necessarily do so. Palermo and Naples were formerly powerful Italian cities that had been co-capitals of the Kingdom of the Two Sicilies that had been in none too graceful decline since the 13th century. What were they missing?

If there was something like yeast at work in Europe, it must have been in units larger than cities, i.e., in states or empires. It took several more years to understand the role of states in development, and then of the role of competition among the states as a spur to development. This uncertainty of how states might be an essential element in the wealth generation process drove me to reexamine how I thought about governance. My training had been based upon the notion of strategy for the mobilization and application of resources for wealth generation, and of organizational structure for its control and utilization, as the operational concepts for understanding the development of firms. However, there was no clear idea of governance in the model. The model was built on a "managerial" model of capitalism whose roots were in Alfred Chandler's classic work *Strategy and Structure*, and subsequently developed in his prize-winning *The Visible Hand*, where the roles of the board of directors and the shareholders had not been fully developed. As a result, my ideas on corporate governance were much less developed than those on strategy, and they were if anything even less applicable to countries or societies. Creating a framework for understanding how countries governed their economies became the central intellectual challenge in this research.

Two important developments suggested a way forward. First, in 2000 I began to think of competition among economic actors (e.g., firms) in an economy as analogous to competition of teams in organized sports. I do not remember a particular moment when this idea occurred, and it took a number of tries to work out the three-level structure of organized sports before it could be applied to capitalism. As I worked out the sports analogy, I relied on Jamie to help me restrain my enthusiasm for the device until I was certain that it would hold up well to its task. The critical insight was to get beyond looking only or even primarily at the competition between two teams on a playing field in order to see an organized sport as a whole; with a political authority for its governance, and a set of rules for play monitored by appointed officials, whether the playing field accommodated two teams at a time, or 20, or perhaps 2,000. Capitalism has many competing teams,

²For example: Antwerp and Rotterdam were centers of trade; Istanbul was a center of trade as well as the capital of an empire; Madrid was a capital with little trade; and Rome was a former world capital with little trade or political power.

of very different sizes, but still the competition is based on a set of rules that apply to all and that are formally monitored for compliance, with regulatory decisions that are backed up by coercive force if need be. The capitalist parallel was to formally organized sports, not to informal sports played among family or friends in an unmarked field or a back yard. Informal sports were more nearly parallel to an economy based on barter. Europe presented itself as a uniquely fortunate natural experiment, with its 300–500 competing political entities in 1500; they were reduced to only 40 in 1820, paralleling the “shakeout” that routinely takes place in new industries in modern times. How was European political competition organized, if that was indeed the right term to use, and who had organized it and how? What were the keys to survival in such a context, and the costs of a takeover by a rival power?

Second, the notion of formal competition also called for recognizing the importance of legal systems, through which societies themselves were formally organized. I realized that those legal systems needed to be part of my analytic framework if I was to understand how and why some societies might outperform others. The underlying idea was that sports teams, and firms, and even entire societies were all open systems wherein a governing authority created a system of governance for its society and a strategy for enhancing the interests of that particular system in its environment, an idea that had been central to my doctoral thesis, “An Open System Model of the Firm.”³ All social systems could be looked at as open, and all could be expected to have emergent strategies and processes of governance for advancing their interests. However, these strategies and processes required the visible hand of human agency; they required powers of governance to modify their policies and institutions to improve performance instead of just adjusting supply and demand to achieve a new equilibrium. There was evolution in such a system, but it was not like biological evolution in the sense of allowing the environment to determine which varieties were naturally selected by that environment. Variety could be internally generated by the visible hands of political leaders, and a preferred variety could be selected and backed by resources mobilized by those visible hands. A human system could make purposive choices which might not be optimal in the short run, like taking a step backward in order to take three steps forward, a point made by Sumantra Ghoshal in his exceptionally perceptive paper, “Bad Management Theories Are Destroying Good Management Practices.”⁴

Whereas systems theory taught me to recognize that all living things could be recognized as parts of one or more systems, it also taught me that it was of fundamental importance to be clear just which systems they might belong to, and to

³Bruce R. Scott, “An Open System Model of the Firm” (DBA dissertation, Harvard Business School, 1962).

⁴Sumantra Ghoshal, “Bad Management Theories Are Destroying Good Management Practices,” *Academy of Management Learning and Education* 4, no. 1 (2005): 75–91.

analyze their activities in light of such systems. For instance, to understand capitalism as a system it was important to recognize that seeing capitalism as equivalent to the activities of firms in markets was a very shallow, incomplete notion of any such system. There needed to be recognition of rules of behavior and of referees to monitor and enforce those rules. On the other hand, the notion that all individuals could be seen as atomistic entities, unrelated to their surrounding human groups and the rules of behavior governing such groups, was clearly reductive. Convenient because it allowed all individuals to be classed as though they were essentially identical building blocks or atoms, like the basic particles of physics, yet each with rational expectations so that humans could be considered in isolation from one another, and without distinctive personalities, this expectation was and remains a gross oversimplification of reality and about as unscientific as it could be. It was the grist that was needed for mathematical model building, but not a good basis for understanding the behavior of people in organizations. Unrelated individuals could be expected to behave differently from tightly knit groups of the same size, even if the individuals looked and weighed about the same. Hierarchically organized groups could be expected to behave differently from others with a flat or egalitarian structure, and so on. Sociology mattered as well as political science, law, and economics. The traditional analytical tools of economics were not adequate to the task I had undertaken.

The Origins of Capitalism

It was at this stage that I began to experience some cumulative learning. Rivalry among states put a premium on military power, which, in the period from 1400 to 1800, depended on hiring mercenaries. The need for mercenaries made it clear that countries were *Sovereign, But Unequal*, which became the provisional title of the book.⁵ Successful states could more easily afford to meet their need for mercenaries in order to avoid a “hostile takeover.” Hostile takeovers in this political competition might be very harsh, often leading to the execution of political leaders of the old order. There was a huge incentive to raise incomes to increase the tax base to permit hiring more troops, i.e., to adopt a mercantilist strategy for defense if not offense. Europe was building its economic institutions, such as banks, paper currencies, and bills of exchange, in part to help develop its incomes and thus the tax base to finance defense. The efficiency as well as the legitimacy of these institutions depended upon their national legal systems, and not least on how well they protected creditors. A better credit rating for a society could reduce borrowing costs by as much as two thirds, which meant that a comparably sized country could support far more troops. So societies could have strategies and structures of governance to advance their interests, and size did not directly translate itself into power. As with firms, strategies

⁵See Bruce R. Scott, “The Great Divide in the Global Village,” *Foreign Affairs* 80, no. 1 (January/February 2001): 160–177.

and structures made a difference. The Netherlands became a veritable powerhouse in the 17th century with only about one million people, thanks to a strategy that yielded a sound credit rating, low interest costs, and thus great borrowing power in case of an emergency, a set of circumstances I explore in Chap. 5.

But where was one to start an analysis of the evolution of systems as complex as whole societies? Fortunately, there were some remarkable lessons to be gleaned from examining the circumstances and results of the European settlement of the Western hemisphere, where virtually new societies were built from scratch, as if in a natural experiment. It was my good luck to encounter some remarkable research of Stanley Engerman and Kenneth Sokoloff, who had recently published pioneering work in analyzing this situation and explaining subsequent income divergence. Tracing alternative production systems and their implicit strategies and associated governance systems back to the factor endowments upon which they were built, Engerman and Sokoloff downplayed explanations based on European culture or legal systems, let alone distance from the equator. Instead, they found that rich factor endowments induced the development of characteristic production systems (based on forced labor) whose governance systems were also based upon force, and which overpowered other factors, such as the theoretical powers of a democratically elected parliament.

Jamaica was a particularly powerful example of the role of governance in development. In the 1700s it had British law formulated by a British-style parliament, but as a framework for the enforcement of slavery and not as a framework for individual development through the protection of civil liberties let alone for democratic governance. Jamaica's production system had a distinctive set of institutions based upon slavery, and slave-based systems seemed to be broadly similar whether governed by British, Dutch, French, Portuguese, or Spanish law. In the Jamaican case, British law was used as the basis for the ruthless repression of the black majority by a tiny white oligarchy, as explained in Chap. 6. An MBA education helped me see these relationships between the macroeconomy and the different production systems on which they might be built.

A similar logic applied in North America, but the demographics were different as well as the richness of the factor endowments. The initially higher incomes in the US South were also based on plantation agriculture, which depended upon slavery, where the system was devised and supervised by a tiny elite of English-speaking pseudo-capitalists. Governance systems that included slavery were the antithesis of capitalism: labor was not free to search out its most effective usage. Such systems led to underdevelopment of public goods such as roads and police protection, and, eventually, to underdeveloped education systems and underdeveloped human resources. British law could be used to enslave the inhabitants or to promote their freedoms; the key factors that shaped the fortunes of the various colonial regimes lay in the governance of their respective political systems and not in the legal systems *per se*.

Rich factor endowments in the South foretold the creation of exploitative production systems run for the benefit of privileged elites, and the policies and institutions created by these elites stunted the opportunities for most inhabitants, foretelling their

eventual underdevelopment relative to the North. However, in the United States the slave populations rarely exceeded 20% of the total. In political terms slavery was always a minority proposition in the United States, and thus much less of a threat to democratic governance. The white settlers could expect to dominate in any of the states. In 2006, with this broadened scope of analysis and with the encouragement of the editor, I shifted the book's emphasis from strategy to governance and, accordingly, the title to *Capitalism, Democracy, and Development*. Explicit recognition of governance in the title came three years later.

The Evolution of Capitalism

The US economic histories that I read initially shared a weakness with Braudel's account of the rise of Europe: they overlooked human agency as an explanatory factor in the story. As Robert Lachmann noted of Braudel's magnum opus, the great master was satisfied with description, and that is not equivalent to explanation. Looking for explanations of US economic development and the rise of oligarchy during two separate eras, 1830–1937 and 1980–2009, I found mostly descriptions of those periods, as well as accounts of the interim period, 1950–1980, when a socially democratic United States more closely resembled Europe. The lack of explanation was less pressing in analyzing the first 200 years of development in the United States, circa 1630–1830, described by Research Associate Sarah Potvin in Chap. 7 because it is an iconic case study of the atomistic society explained by Adam Smith in his *Wealth of Nations*. But, initially, I was not able to provide the readings or ideas that Sarah needed to draft what is now Chap. 13.

I looked further afield, to my earlier experiences with US history at Swarthmore College. Some of the notions of US experience with oligarchy were familiar from my classes with professors such as Clair Wilcox, Joseph Conard, and Frank Pierson, all of whom were interested in economic history. In addition, some were anticipated in periodic discussions with my father, a graduate of the University of Chicago and its Law School, and a senior attorney for the Burlington Railroad. He came at the world from a much more conservative perspective than the Swarthmore faculty that I knew best. In addition, some of my ideas came from my mother, who had studied economics—or “commerce”—at the University of Chicago and worked there for perhaps 5 years afterwards as a researcher in the employ of a distinguished economist and future Senator, Paul Douglas.

However, the decisive role of human agency in the development of the United States in the 19th century was only brought to my attention through a chance conversation at the Faculty Common with Rakesh Khurana and Scott Snook, two sociology professors who were friends and faculty colleagues at Harvard Business School. In the spring of 2007, following many months of frustration studying economic histories that were largely passive descriptions, they pointed me to Charles Perrow's study of two different American developmental models early in the 19th century, one built around clusters of small firms, and the other permitting the growth of

giants.⁶ Whereas the work of Alfred Chandler had made the second model look imperative, Perrow argued, persuasively in my view, that there were decisions to be made by the entrepreneurs and also by legislatures, courts, and the executive branch of government, which had, in fact, shaped the US capitalist model.

When human agency is taken into account, the story of US industrial development in the 19th century becomes one of competition between those who wanted to empower firms to grow and become more productive and inevitably more powerful politically as well as economically, and those who wished to establish a regulatory framework to protect the public from the abuse of private power by those same firms, for instance, through regulation of railroad rates and/or by restricting the rights of firms to grow through mergers and acquisitions. If the development of the new technologies of the Industrial Revolution was on the side of empowerment of firms, the creation of regulatory agencies at the state level was supposed to be on the other side. But often it was not. For instance, the Fourteenth Amendment, which was originally passed to protect the rights of the recently freed slaves from abuse by state governments through the agency of due process of law, and federal law at that, was soon used to protect essentially white firms from regulation by those same state governments.

Here it gradually became clear to me that US capitalism was quite unlike any other, and in ways that were generally unfamiliar to educated Americans, including those who received MBAs from US business schools. The powers of the US government to regulate the activities of US firms might well be far weaker than the corresponding powers of governments in many other industrial countries. While there could be several reasons for such sweeping differences, one had been built into the Constitution. Whereas most countries required their firms to have a charter from the central government, and such charters typically required that the powers granted through such a charter be used broadly for the public benefit in what is called “stakeholder capitalism,” the United States was virtually unique in not locating authority for chartering at the federal level, but rather at the level of state government. The states, now numbering fifty, have oftentimes competed to attract investment by weakening their corporate regulatory and tax environments and firms have been responsive to such lures. As a result, US firms have no mandated mission to contribute to society, only to obey the laws and regulations of the state and federal governments.

Thus, the US legal system has been used to greatly enhance the power of firms as well as to regulate them, and the governance issue was to understand the balance between that empowerment and regulation. Harvard Law School Professors Duncan Kennedy and Morton Horwitz have explained the development of certain key legal concepts, and how they played a distinctive and very powerful role in promoting the empowerment of firms, a set of circumstances that was largely unfamiliar to me as

⁶Charles Perrow, *Organizing America: Wealth, Power, and the Origins of Corporate Capitalism* (Princeton, NJ: Princeton University Press, 2002).

we began the research for Chap. 13. Much of the literature was ignoring the constitutive role of the state in the empowerment of firms on the one hand, and its more or less adequate role as a regulator on the other. All of this seems obvious to me now; but at the time it was anything but. The prevailing legal theory of the period from 1870 until 1937 was developed in an era when Republicans controlled the White House 75% of the time (between 1860 and 1932), and, as a result, the Supreme Court during that era had an almost continuously conservative tilt, which reshaped US law and indeed US economic development. Furthermore, competition in “regulatory laxity” among the states rendered charters of incorporation virtually legal formalities; states conferred rights with minimal corresponding responsibilities.

These crucial formative circumstances were radically different from those in most if not all other industrial democracies. Indeed, the laxity of standards of incorporation in the United States continues to distinguish the United States from much of the rest of the world. Thus, in looking at the 19th century, the active competition for economic and political power—as well as the forces that shaped that competition and the impact it exerted on institutions—emerges as continually relevant. The shift in power away from the states and toward firms seems more important to me than the shift in incomes among individuals toward the more affluent. However, a rebalancing of this power relationship between the firms and their erstwhile regulators was only achieved through a constitutional confrontation between the President and the Supreme Court, in 1937. The *de facto* resolution of this conflict gave the United States a capitalist system with a policy tilt much more similar to those in other industrial countries, a situation that would last until about 1980, when the United States would once again move toward its uniquely business-oriented *laissez-faire* model.

This 19th century history became clear to me as I prepared to give a seminar in Ottawa, Canada, in June of 2008, to the Harvard Business School Alumni of that region. The occasion was a program organized by Alain Martin for their club members and guests. When Alain asked if I would come give a talk to his members on US capitalism, I set as my two conditions that it be an all-day meeting and that it conclude with a Canadian panel that would comment on the differences and similarities between US and Canadian capitalism. I was surprised that Alain accepted to even try, and even more that he succeeded in finding about 70 participants.

As the meeting approached, I was charged with learning to teach what is now Chap. 13, recently completed with the expert assistance of Research Associate Linnea Meyer. As part of that preparation, I asked Linnea to look into the 1937 confrontation between Franklin Roosevelt and the Supreme Court. Linnea returned with a book by Robert Jackson, who had served as a Supreme Court Justice and, eventually, the chief war crimes prosecutor at Nuremberg.⁷ As it turned out, Jackson was FDR’s Solicitor General during that confrontation, and his book gave a powerful account of what was at stake for US democracy as well as capitalism in this confrontation. Drawing on Oliver Wendell Holmes, Jr., Jackson laid out his

⁷Robert H. Jackson, *The Struggle for Judicial Supremacy: A Study of the Crisis in American Politics* (New York: Alfred A. Knopf, 1941).

vision of the role of a Constitution in considering the various forms of capitalism: the Constitution should not legislate a form of capitalism but should instead provide a framework in which such choices could be made by Congress, which would roughly parallel European constitutional practices. However, the confrontation between Roosevelt and the Supreme Court was not settled on the basis of principle but rather resolved by a tactical accommodation. As Jackson notes, that basic constitutional issue remains unresolved; today, it is again a source of tension, as Jackson warned that it might be.

In response to my lecture on that history, the Canadians at the HBS meeting explained that their democracy worked quite differently from the American model. The Canadian Constitution, promulgated in 1867, had been inspired by front row seats for the recently concluded US Civil War, rather than the American Revolution against the tyrannies of King George and his ministers. As a result, the Canadian Constitution spoke far more of government's obligations than of citizen rights, i.e., peace, order, and good government, without mention of life, liberty, and the pursuit of happiness. Canada had not deregulated its financial sector in the 1980s, and consequently had curbed any outbreak of irresponsible borrowing or lending before it started, thus sparing its economy exposure to anything like the financial leverage the US had allowed. The Canadians on the panel included Raymond Chrétien, former Canadian Ambassador to the United States (1994–2000); Barbara Stymiest, Chief Operating Officer of the Royal Bank of Canada; Gaëtan Lussier, Chairman of the Canadian Agri-Food Policy Institute; and Joseph Martin, Director of Canadian Business History at the University of Toronto's business school. Charles Morris, an American "guest" and the author of *The Trillion Dollar Meltdown*, joined the panel as a bearer of news on the US capitalist system.⁸ It was a great opportunity for the Canadians to appreciate the value of the visible hand of their government in the form of effective regulation, while wondering out loud how it was that Americans could tolerate such an "obviously corrupt" system. It was a question that begged for an answer and perhaps even a sequel meeting in Ottawa.

Capitalism Today

Chapter 14, which examines changes in US capitalism and democracy since 1965, turned out to be the most difficult to research and write, as the recent history described in the chapter has not yet been explored and explained by many scholars. I was disappointed, for example, not to find a satisfying explanation of the Reagan administration's strategy of deregulation, though much has been written on the fiscal policies of Reaganomics.

Deregulation in the United States did not begin as an economic policy, nor did it originate with Reagan. As I inquired, it became clear that deregulation started in the area of social policies, as early as the 1960s. Social deregulation had a very different

⁸Charles R. Morris, *The Trillion Dollar Meltdown* (New York: Public Affairs, 2008).

logic from economic, and the most powerful effects of both were felt in the political system; these circumstances were identified and analyzed by Fareed Zakaria in *The Future of Freedom*.⁹ Further, starting in the mid-1970s, the deregulation of the political system had the unintentional effect of ceding political power to the private sector, in a set of circumstances that have been of fundamental importance both to the governance of the United States and indeed to the world. Yet these changes have not been widely appreciated, and most especially not in the United States itself. Rather, starting in 1981, it became fair to speak of a revival of business oligarchy in a pattern not repeated in many, if any, other industrial democracies. Why did it happen in the US for a second time, when the federal government was undoubtedly the most powerful political authority in the world?

In my analysis, this third transformation of US capitalism¹⁰ was driven in part by broad societal forces, which I explain at some length at the beginning of Chap. 14 because of their extraordinary importance to capitalism the world over. At the same time, part of the transformation of US capitalism came from a change in the managerial models of US firms, most notably from stakeholder capitalism to shareholder capitalism, or more realistically to capitalism for the elites in charge of the firms. This change in governance was assisted by the addition of extraordinary levels of incentive compensation for top managers. Here, by serendipity, my years researching and writing about the management of firms, in Europe as well as the United States, came in handy. US firms were embracing a shareholder-oriented version of capitalism which, with the self-assured guidance of Milton Friedman and Michael Jensen and others, argued that the firm had no responsibilities to society in return for the powers conferred by its charter, other than those obligations explicitly spelled out in the laws and regulations, which they knew (or should have known) to be very imperfect and thus riddled with negative externalities. Furthermore, deregulation was reducing societal responsibilities while the continuing growth of lobbying and political corruption was opening the prospects for the private sector to capture more and more of the rights to govern the system in preference to elected officials. It was sure to increase the inequalities of power as well as incomes, which was rapidly evident.

In analyzing the oligarchic takeover of US governance, it was important to recognize that, in both the 19th and 20th century cases, US democracy had been transformed alongside US capitalism. The addition of Chaps. 3 and 4 provided foundational chapters on US democracy, creating a conceptual base for an analysis of US democracy in parallel to Chap. 2, which introduced theories of capitalism. But the emergence of shareholder capitalism made the US situation radically different from most other countries, a situation that I could not explore in depth.

⁹Fareed Zakaria, *The Future of Freedom: Illiberal Democracy at Home and Abroad* (New York: W.W. Norton, 2004).

¹⁰As explained in the concluding chapter, I have classified US capitalism as having experienced four phases, and hence three transformations.

In 2009, thanks to a suggestion from Springer editor Niels Thomas, we changed the title of the book once again, to its current incarnation, to reflect the fact that capitalism was an evolving or emergent system, and not one that was either natural or fixed. It was an evolving system with the need to continually rebalance the relative powers of the public sector and private. Capitalist evolution was, in part, the outcome of political competition within a country, where the regulatory processes could be reduced or even subverted in this competition. Uniquely, in the US case, the laws could also be changed by the Supreme Court, as sovereignty was divided among the three branches, a point that was once again apparent when the Court overturned previous precedents to clear the way for virtually unlimited political spending by corporations and unions as part of their newly recognized rights to free speech under the Supreme Court's interpretation of Article One of the Constitution.

But there were other evolutionary issues in the historical materials as well. Europeans established permanent settlements in South America about a century before doing so in the area that would become the United States. All the same, my reading of the available sources strongly suggests that capitalism came to North America about 200 years before it was adopted anywhere in South America, a possibility which seems little recognized. I suggest that the United States and Canada passed Latin America because of this head start with capitalism. Here again, political issues delayed the establishment of Latin American factor markets by centuries. Getting that history straight may help focus attention on the role of *capitalism* relative to *capital* in the development process, as I argue in Chaps. 6 and 7. This line of analysis would suggest that the European approach to spreading their community through adoption of thousands of pages of regulations to be superior to the promotion of development largely on the basis of free trade. Free trade does not spur development unless a country or region has something of value to trade, and agricultural commodities tend to be toward the bottom of the value chain, as Erik Reinert has explained in his book *How Rich Countries Got Rich and Why Poor Countries Stay Poor*.¹¹ Further, free trade only induces much development in countries with the political capacities to reform their institutions for their own advantage.

Chapter 5, on the Origins of Capitalism, was written mostly in 2000 and 2001, or almost at the start of my examination of governance. In retrospect the definition of capitalism was the key conceptual contribution from which others flowed because it permitted a much more accurate identification of its origins as well as some of the key steps in its evolution, but this significance only became apparent to me gradually as the work progressed, and especially through the case examples in Chaps. 6 and 7. Had I recognized it sooner, I might have chosen to write Chap. 5 with more historical detail. For example, with an explicit definition of capitalism as a system of governance it was clear that Venice was the historical leader thanks to its limited

¹¹Erik S. Reinert, *How Rich Countries Got Rich and Why Poor Countries Stay Poor* (London: Constable, 2007).

monarchy (dukedom), and thus a stable yet evolving system of governance for at least 1,000 years prior to the arrival of Napoleon's armies, and the text could easily be adjusted to incorporate this insight. Furthermore, it was clear that most of Europe did not have capitalism by 1800 or even 1820. France became capitalist at some point after the overthrow of feudalism in 1789, but not before several attempts to establish limited monarchy in the 19th century. Similar transformations came even later in Austria, Italy, Prussia, and Spain. In addition, I was surprised to discover that the US would establish capitalism along its East Coast early in the 17th century, centuries ahead of some of the major European States. Adopting capitalism centuries ahead of most of the world seems to have been a clear American advantage, even if it was an atomistic form of capitalism which would become anachronistic in the context of its industrial giants from the 1840s onward.

A more troubling issue to be dealt with was the financial crisis that became visible in August of 2007, when first the European Central Bank and then the Federal Reserve had to make huge injections of cash into the financial markets before they opened on a Monday morning. I sought advice on this, including from author Charles Morris (*The Trillion Dollar Meltdown*¹²) and investor/philanthropist George Soros. Following the Lehman Brothers bankruptcy, these inside observers were in agreement that lax regulation was not the platform for freedom for the market participants so much as a platform for irresponsible behavior by the private sector and ultimately for chaos. Financial markets were not self-regulating any more than competition between hockey teams which could use their sticks as clubs. What was needed was a better understanding of how capitalism worked, and how and why so many otherwise wise people, such as Alan Greenspan, could believe that financial markets were both efficient and essentially self-regulating. This book aims to explain how it works and why it cannot be self-regulating. It will not try to explain why those basic realities are not apparent to some very smart people. I put this material in an epilogue to reflect the obvious notion that this only reflects something close to instant history describing a story that will be researched for decades to come, and obviously much better understood in that process.

Finally, I tried to draw some conclusions. In that process, I return to my central theme, the role of US capitalism and democracy in the US and still more in the world. Here I draw on the concepts and evidence in the book to evaluate a contemporary Capitalist Manifesto which I find very superficial and therefore not reassuring at all. Some of our leading political scientists have been right when they recognize capitalism as a system of governance, and they follow this by saying that it is such a complicated system that they cannot say much more. Unfortunately many economists still seem to have failed to recognize it as a system of governance, which leaves them trying to explain how legislatures set policies and institutions in terms of quasi-automatic cost-benefit analyses or through some form of subversive capture of the political authorities. The notion that this process of capture depends on the distribution of wealth generated by a particular variant of capitalism does not get the

¹²Morris, *The Trillion Dollar Meltdown*.

recognition it deserves. A grossly unequal distribution of income and wealth has the potential to subvert the democratic political process anywhere anytime. The systems of capitalism and democracy act to transform each other, as Gabriel Almond has so ably pointed out.

There is much to be learned in this field of political economy, and hopefully ways will be found to break down the artificial barriers that have imposed limits on various disciplines. I intend this book as a step in that direction, one of historically based multidisciplinary research that eschews grandiose modeling that runs far beyond any empirical base. Perhaps there is something to be learned about academic scholarship from this experience. An outstanding liberal arts education can still be a valuable starting point for comparative research in the historical development of governance systems.

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Capitalism

Its Origins and Evolution as a System of Governance

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