Redefining capitalism

Despite its ability to generate prosperity, capitalism is under attack. By shaking up our long-held assumptions about how and why the system works, we can improve it.

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Capitalism is under attack. The financial crisis of 2008, the stagnation of the middle class in many developed countries, and rising income inequality are challenging some of our most deeply held beliefs about how a fair and well-functioning society should be organized.

Many business leaders are of two minds about the situation. They note that market capitalism has yielded massive increases in human prosperity, particularly in the West in the 19th and 20th centuries. More recently, it has lifted hundreds of millions from poverty in emerging economies. Yet despite these historic accomplishments, it's also easy to worry that something is wrong with how the system is performing today.

This article will argue that while we have been correct to believe that capitalism has been the major source of historical growth and prosperity, we have been mostly incorrect in identifying how and why it worked so well. By analogy, our ancestors did *know* that the stars and planets moved in the sky and had various theories to explain their observations. But it wasn't until the Copernican model replaced the Earth with the sun at the center of the solar system and Newton articulated his laws of gravitation that people understood *how* and *why* they move.

Likewise, the conventional economic theories we have relied upon for the past century have misled us about the workings of capitalism. Only by replacing our old theories with better and more modern ones will we build the deeper understanding necessary to improve our capitalist system.

Rocking-horse versus wild-horse economics

For the past century, the dominant economic paradigm—neoclassical economics—has painted a narrow and mechanistic view of how capitalism works, focusing on the role of markets and prices in the efficient allocation of society's resources. The story is familiar: rational, self-interested firms maximize profits; rational, self-interested consumers maximize their "utility"; the decisions of these actors drive supply to equal demand; prices are set; the market clears; and resources are allocated in a socially optimal way.

Over the past several decades, though, some of the bedrock assumptions of neoclassical theory have begun to unravel. Behavioral economists have accumulated a mountain of evidence showing that real humans don't behave as a rational *homo economicus* would. Experimental economists have raised awkward questions about the very existence of utility; and that is problematic because it has long been the device economists use to show that markets maximize social welfare. Empirical economists have identified anomalies suggesting that financial markets aren't always efficient. And the macroeconomic models built on neoclassical ideas performed very poorly during the financial crisis.

Andy Haldane, the chief economist of the Bank of England, notes that the conventional theory views the economy as a rocking horse that, when perturbed by an outside force, sways for a while before predictably settling back down to a static equilibrium. But, as Haldane has pointed out, what we saw during the crisis was more like a herd of wild horses—something spooks one of them, it kicks another horse, and pretty soon the whole herd is running wildly in a pattern of complex, dynamic behavior.[1] Andy Haldane discussed these views in a speech on November 11, 2013, at an event held by the United Kingdom's Treasury: "Teaching economics as if the last decade mattered."

In the years before the crisis, a new view of economics began to stir. Since the crisis, it has begun to blossom.[2] See Eric D. Beinhocker, *The Origin of Wealth: Evolution, Complexity, and the Radical Remaking of Economics*, Boston, MA: Harvard Business School Press, 2006; and Nick Hanauer and Eric Liu, *The Gardens of Democracy: A New American Story of Citizenship, the Economy, and the Role of Government*, Seattle, WA: Sasquatch Books, 2011. This view holds that the economy is a constantly evolving, interacting network of highly diverse households, firms, banks, regulators, and other agents, more like Haldane's wild herd than a rocking horse. The economy—a complex, dynamic, open, and nonlinear system—has more in common with an ecosystem than with the mechanistic systems the neoclassicists modeled their theory on. The implications of this emerging view are only just beginning to be explored. But the two of us believe it has fundamental implications for how people think about the nature of capitalism and prosperity.

Significantly, this view shifts our perspective on how and why markets work from their allocative efficiency to their effectiveness in promoting creativity. It suggests that markets are evolutionary systems that each day carry out millions of simultaneous experiments on ways to make our lives better. In other words,*the essential role of capitalism is not allocation—it is creation*. Life isn't drastically better for billions of people today than it was in 1800 because we are allocating the resources of the 19th-century economy more efficiently. Rather, it is better because we have life-saving antibiotics, indoor plumbing, motorized transport, access to vast amounts of information, and an enormous number of technical and social innovations that have become available to much (if not yet all) of the world's population. The genius of capitalism is that it both creates incentives for solving human problems and makes those solutions widely available. And it is solutions to human problems that define prosperity, not money.

Prosperity redefined

Most of us intuitively believe that the more money people have, the more prosperous a society must be. America's average household disposable income in 2013 was $38,001, versus $28,194 for Canada[3] *OECD Better Life Initiative*, OECD Better Life Index: Country Reports, 2013, oecd.org.; therefore, people believe, America is more prosperous than Canada.

But the idea that prosperity is simply about having money can be disproved with a simple thought experiment. Imagine you had the $38,001 income of a typical American but lived among the Yanomami people, an isolated hunter-gatherer tribe deep in the Brazilian rainforest. You'd easily be the richest of the Yanomami (they don't use money, but anthropologists estimate their standard of living at something around $90 a year).

But you'd still feel a lot poorer than the average American. Even after you'd fixed up your hut, bought the best baskets in the village, and eaten the finest Yanomami cuisine, all of your riches still wouldn't get you antibiotics, air conditioning, or a comfy bed. Yet even the poorest Americans typically have access to these important elements of well-being.

This is why prosperity in human societies can't be properly understood by looking just at monetary measures, such as income or wealth. Prosperity in a society is *the accumulation of solutions to human problems*.
These solutions run from the prosaic (crunchier potato chips) to the profound (cures for deadly diseases). Ultimately, the measure of the wealth of a society is the range of human problems it has solved and how available it has made those solutions to its people. Every item in a modern retail store can be thought of as a solution to a different kind of problem—how to eat, dress, entertain, make homes more comfortable, and so on. The more and better the solutions available to us, the more prosperity we have.

Growth redefined

We typically talk about growth in terms of GDP, though it has been much criticized recently as a measure of progress. There have been a variety of attempts to make GDP account for things such as environmental damage, unpaid work, the progress of technology, or the development of human capital.

In our view, the biggest problem with GDP is that it doesn't necessarily reflect how growth changes the real, lived experience of most people. In the United States, for example, GDP has more than tripled over the last three decades. Although those increases have been concentrated at the top of the income spectrum, people across the board have benefited from improvements in technology (say, safer cars, new medical treatments, and smartphones). Other changes, though, have been accompanied by unintended consequences (such as the stress many knowledge workers feel from 24/7 connectivity). Is life actually better or worse for most people? How are the gains of growth shared? GDP cannot answer these questions.

If the concept of growth is to have significance, it should represent improvements in lived experience. If the real measure of a society's prosperity is the availability of solutions to human problems, growth cannot simply be measured by changes in GDP. Rather, *it must be a measure of the rate at which new solutions to human problems become available*.
Going from fearing death by sinus infection one day to having access to life-saving antibiotics the next, for example, is growth. Going from sweltering in the heat one day to living with air conditioning the next is growth. Going from walking long distances to driving is growth. Going from needing to look up basic information in a library to having all the world's information instantly available on your phone is growth.

Growth is best thought of as an increase in the *quality and availability* of solutions to human problems. Problems differ in importance, and a new view of growth must take this into account: finding a cure for cancer would trump many other product innovations. But in general, economic growth is the actual experience of having our lives improved.

This is different from other alternative measures of growth. For example, research shows that happiness does not necessarily correlate with GDP growth—Bhutan has even famously developed a Gross National Happiness (GNH) Index. Likewise, the United Nations created a Human Development Index (HDI) based on Amartya Sen's theory of human capabilities and freedom. What the two of us are proposing sits somewhere between GDP and these measures. Like GDP, it is intended to be a definition of material prosperity. But it is also a more meaningful way of thinking about material standards of living than GDP.

Can the rate at which solutions appear and their availability be measured? While such a measure has not been tried yet, we believe it is possible. Inflation is measured by looking at changes in the prices of goods and services in a "basket" typically consumed by households. Similarly, it's possible to look at how the actual contents of such a basket are changing across time or how they differ across countries or levels of income. What kind of food, housing, clothing, transport, healthcare, education, leisure, and entertainment do people have access to?

Capitalism redefined

If prosperity is created by solving human problems, a key question for society is what kind of economic system will solve the most problems for the most people most quickly. This is the genius of capitalism: it is an unmatched evolutionary system for finding solutions.

Finding new solutions to human problems is rarely easy or obvious—if it was, they would have already been found. For example, what is the optimal way to solve the problem of human-powered transportation? There are a multitude of options: bicycles, tricycles, unicycles, scooters, and so on. Human creativity develops a variety of ways to solve such problems, but some inevitably work better than others, and we need a process for sorting the wheat from the chaff. We also need a process for making good solutions widely available.

Capitalism is the mechanism by which these processes occur. It provides incentives for millions of problem-solving experiments to occur every day, provides competition to select the best solutions, and provides incentives and mechanisms for scaling up and making the best solutions available. Meanwhile, it scales down or eliminates less successful ones. The great economist Joseph Schumpeter called this evolutionary process "creative destruction."

The orthodox economic view holds that capitalism works because it is *efficient*. But in reality, capitalism's great strength is its problem-solving creativity and*effectiveness*. It is this creative effectiveness that by necessity makes it hugely*inefficient* and, like all evolutionary processes, inherently wasteful. Proof of this can be found in the large numbers of product lines, investments, and business ventures that fail every year. Successful capitalism requires what venture capitalist William Janeway calls "Schumpeterian waste."[4] William H. Janeway,*Doing Capitalism in the Innovation Economy: Markets, Speculation and the State*, Cambridge, UK: Cambridge University Press, 2012.

The role of business

Every business is based on an idea about how to solve a problem. The process of converting great ideas into products and services that effectively fulfill fast-changing human needs is what defines most businesses. Thus, the crucial contribution business makes to society is *transforming ideas into products and services that solve problems*.

This sounds simple and obvious, and many executives would say, “Of course that is what we do.” But again, that is not what standard theory says businesses*should* do. In the 1970s and 1980s, academic work based on neoclassical theory argued that maximizing shareholder value should be the sole objective of business. If corporations just did this, said these professors, they would maximize overall economic efficiency and social welfare. This focus did correct some deficiencies in the previous system, most notably by empowering shareholders to push back against CEOs who maximized the size of their empires rather than economic returns.

But some argue that elevating the creation of shareholder value to the status of primary objective is based on a faulty assumption—that capital is the scarcest resource in an economy, when in reality it’s knowledge that’s the scarce, critical ingredient in solving problems.[5] Clayton M. Christensen and Derek van Bever recently called the assumption of capital scarcity into question in “The capitalist’s dilemma,” *Harvard Business Review*, June 2014, hbr.org.It has also led to a myopic focus on quarterly earnings and short-term share-price swings, to say nothing of a decline in long-term investment.[6] See Dominic Barton and Mark Wiseman, “Focusing capital on the long term,” *Harvard Business Review*, January–February 2014, hbr.org, for more on the unintended consequences of maximizing shareholder value. This is in startling contrast to the attitudes of even the recent past. If you asked a CEO in the 1950s, an era of tremendous prosperity growth, what his job was, his first reply would probably have been “to make great products and services for customers.” After that, the CEO might have said something about looking after his company’s employees, making profits to invest in future growth—and then, finally, giving the shareholders a decent, competitive return.

We believe that a reorientation toward seeing businesses as society’s problem solvers rather than simply as vehicles for creating shareholder returns would provide a better description of what businesses actually do. It could help executives better balance the interests of the multiple stakeholders they need to manage. It could also help shift incentives back toward long-term investment—after all, few complex human problems can be solved in one quarter.

This is not to say that shareholders or other owners are unimportant. But providing them with a return that is competitive compared with the alternatives is a boundary condition for a successful business; it is not the *purpose* of a business. After all, having enough food is a boundary condition for life—but the purpose of life is more than just eating.

Some companies already think in these terms. Google, for example, defines its mission as “to organize the world’s information and make it universally accessible and useful”—a statement about solving a problem for people. And it famously refuses to provide quarterly financial forecasts.

Government redefined

Traditional economic theory holds that markets are efficient, inherently maximize welfare, and work best when managed least. But such perfect markets don't seem to exist in the real world. Furthermore, this view fails to recognize that the great genius of capitalism—solving people's problems—has, by necessity, a dark side: the solution to one person's problem can create problems for someone else.

This is the age-old puzzle of political economy: how does an economic system resolve conflicts and distribute benefits? A fancy derivative product may help corporate treasurers solve their problem of managing corporate risk, and it might make bankers rich, but it might also create greater systemic risk for the financial system as a whole. Likewise, eating fatty food may solve someone's problem of satisfying unconscious desires programmed by millennia of evolution. But it might also create new problems of clogged arteries and burden society with that person's future health costs.

It can be challenging to distinguish between problem-solving and problem-creating economic activity. And who has the moral right to decide? Democracy is the best mechanism humans have come up with for navigating the trade-offs and weaknesses inherent in capitalism. Democracies allow its inevitable conflicts to be resolved in a way that maximizes fairness and legitimacy and that broadly reflects society's views.

Seeing prosperity as solutions helps explain why democracy is so highly correlated with prosperity. Democracies actually help *create* prosperity because they do several things better than other systems of government. They tend to build economies that are *more inclusive*, enabling more citizens to be both*creators* of solutions and *customers* for other people's solutions. And they offer the best way to resolve conflicts over whether economic activity is generating solutions or problems. Many (though not all) government regulations are created to do just that—to encourage economic activity that solves problems and to discourage economic activity that creates them—thus fostering trust and cooperation in society.
Businesspeople often complain about regulation—and indeed many regulations are poorly designed or unnecessary—but the reality is that solving capitalism's problems requires the trust and cooperation that good regulation fosters. It is notable that the most prosperous economies in the world all mix regulation with free markets, while unregulated and anarchic economies are universally poor.

What problems do you solve?

Once we understand that the *solutions* capitalism produces are what creates real prosperity in people's lives, and that the *rate* at which we create solutions is true economic growth, then it becomes obvious that entrepreneurs and business leaders bear a major part of both the credit *and* the responsibility for creating societal prosperity. But standard measures of business's contribution—profits, growth rates, and shareholder value—are poor proxies. Businesses contribute to society by creating and making available products and services that improve people's lives in tangible ways, while simultaneously providing employment that enables people to afford the products and services of other businesses. It sounds basic, and it is, but our economic theories and metrics don't frame things this way.

Today our culture celebrates money and wealth as the benchmarks of success. This has been reinforced by the prevailing theory. Suppose that instead we celebrated innovative solutions to human problems. Imagine being at a party and rather than being asked, “What do you do?”—code for how much money do you make and what status do you have—you were asked, “What problems do you solve?” Both capitalism and our society would be the better for it.

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