Big Isn't Beautiful

There's a reason the last people who advocated large cartels haven't gotten a good shake from history: They were wrong. A response to Michael Lind.

Michael Lind's "The Case for Goliath" [Issue #13] offers a new view on some old ideas, including a role for the U.S. government in the post-crisis economy that rejects much of what we know about how modern economies work. Lind is correct to think that the financial system's collapse reveals fundamental weaknesses in the economy. His prescription, however—that we should address these weaknesses by promoting or creating regulated cartels and monopolies across the economy's central sectors, in the service of what he calls "utility capitalism"—is simply wrongheaded.

Utility capitalism would treat the economy's core sectors as privately owned public utilities protected from competition and antitrust, and obliged to guar-

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antee generous wages, benefits, and job security for workers. Lind would like to associate this view with the early Franklin Roosevelt. Yet the last advocates of such cartels were the nineteenth century railroad, banking, and energy barons, while the regulatory guarantees Lind seeks were then the province of the progressives who tore down those baronies. In short, he uses the progressive tool of regulation in the service of the decidedly non-progressive goal of cartelization.

Lind goes further, however, by holding that regulated cartels and monopolies will produce stronger growth and more innovation than America's relatively deregulated brand of capitalism. If these claims were right, the results would constitute a revolution in modern economics. Instead, they bring to mind a famous remark by Daniel Patrick Moynihan: "Everyone is entitled to his own opinion, but not his own facts."

We all can agree that stricter and farther-reaching financial regulation is in order, to protect against yet another economic meltdown. Here's a start that doesn't require reorganizing the U.S. economy: Those who create or purchase financial instruments should have to do so through publicly regulated markets, so basic disclosure and transparency requirements apply to everyone and everything. And those who create or purchase these instruments should have to hold funds equivalent to at least 10 to 20 percent of their value, depending on their risk. Most economists today would support some version of these rules (although, unhappily, they go beyond the Treasury Department's current proposals).

But that's not the regulation imagined under utility capitalism. Financial institutions would be reorganized along cartel lines—the cheering you hear is coming from the Goldman Sachs executive suites—and regulators would determine the instruments they could issue, the interest rates they could charge or pay, and presumably their employees' wages and benefits. It should be obvious that many of our current problems followed from too much concentration in finance, so it's difficult to see why intensifying and formalizing it in a cartel would constitute an advance. Anyway, no cartel regulator can insulate our economy from global capital markets—they would continue to generate new instruments, and collectively they would still determine global interest rates.

The central issue, however, is whether utility capitalism could provide a reasonable model for the real economy—everything outside finance—that would produce stronger growth, income gains, and innovation than one organized around competition. Lind cites a statement by Nobel Laureate Edmund Phelps that productivity grew in the 1920s and 1930s at an unusually fast rate, which we are told was the result of "the New Deal's system of regulated, managerial utility

capitalism." But the cited period covers the 1920s as well as the 1930s; and the '20s were as close to laissez faire as any time in the last century. FDR's NRA plan represented a brief foray into something that might approximate utility capitalism, albeit with limited reach. But that program died a quick, court-ordered death, as Lind notes; while the key regulatory steps that followed in the later 1930s—federal deposit insurance, the Glass-Steagall Act, the Securities and Exchange Commission, Social Security, and so on—looked nothing like utility capitalism.

Lind also attributes the country's strong productivity gains in very recent years to the "quasi-monopolies" of Microsoft and Google. Yet economists trace those productivity gains not to innovative software, but to the market-driven reorganizations undertaken by hundreds of thousands of businesses so they could put to good and efficient use the software and other information technologies developed by hundreds of competing companies. And by the way, Microsoft and Google achieved their own breakthrough innovations as start-ups, not industry titans.

Even in industries that require large resources to develop new products—biotech and other pharmaceuticals, for example—much of the initial innovation comes from small startups, which the big players then purchase to complete the development. This process isn't mysterious: Large, incumbent firms try to enhance the efficiency and reduce the costs of what they already do well. Younger firms have to establish a new place in the market, and since their size precludes competing on price, they have to compete in some area of quality, which often means innovation. Don't take my word for it: Kenneth Arrow, another Nobel laureate, established these dynamics theoretically and empirically some time ago.

But it's the deregulation that started in the 1970s that really riles Lind. Here, he makes his central argument that "monopolistic and oligopolistic corporations are more likely to invest in breakthrough innovation than firms struggling to break even in highly competitive markets." He misreads Joseph Schumpeter to lend credibility to this claim, conflating the role of large companies in generally competitive industries with cartels and monopolies. Then he misstates the views of William Baumol, writing that the "most important innovations originate from large, oligopolistic firms" (Lind's words, not Baumol's). Yet, in the introduction to Baumol's most recent book, (*Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity,* with Robert Litan and Carl Schramm), he and his coauthors note that "it takes a mix of innovative firms and established larger enterprises to make an economy really tick." Nowhere in Baumol or Schumpeter are there suggestions that cartels and monopolies are the way to drive innovation and growth.

Moreover, there are ways to empirically test Lind's proposition about deregulation and innovation. For example, the telecommunications industry was

deregulated in 1996: Did the R&D that produced the sector's innovations rise or fall? The National Academy of Sciences collects these data and reports that even setting aside the bubble years of 1999 and 2000, telecom R&D increased 140 percent in the decade following the 1996 deregulation, on an average annual basis, compared to the decade before deregulation.

Lind also blames the decline of unionism in the late 1970s and 1980s on "the deregulation of heavily unionized industries." That's another testable proposition. Union membership in the deregulated transportation and public utility areas did fall sharply—by more than 1.3 million workers, or 41 percent. But the number of union workers in deregulated finance *grew* by nearly 300 percent (from 55,000 to 155,000). Moreover, the sharpest declines in union workers happened in sectors that the deregulators didn't touch—mining, which went from 369,000 union workers to 117,000, construction (2.6 million union workers to 1.2 million), and of course manufacturing (9.2 million to 4.5 million). There isn't a simple correlation between the decline of unionism and deregulation.

Under utility capitalism, financial regulations would be organized along cartel lines. The cheering you hear is from the Goldman Sachs suite.

Lind moves next to the impact of deregulation on union wages. Here, he cites Michael Wachter, who has attempted to show that antitrust regulation makes it harder to charge the "above-competitive prices to pay those above-market wages." There's no serious evidence for this proposition; in fact, wages rose smartly in the 1990s while the Clinton Justice Department was pursuing lots of antitrust cases but stalled under George W. Bush, whose antitrust lawyers were given little to do. But Wachter's, and presumably Lind's, implicit economics here are instructive. Cartels can charge higher prices than firms in a competitive market, giving them the resources to pay their workers more than market wages. But if those workers receive more than they're worth, somebody else has to get less. Presumably, the regulators would choose. If everybody is to receive more than they're worth, the difference might come out of the returns to the owners. But since investment is a global game, investors would just go somewhere else. After that, who would finance the next stage of innovation and high wages?

It's entirely possible to provide a more extensive safety net for workers without creating utility capitalism. Sweden does it with taxes that take half of its GDP (we take one-third), but it abhors cartels and monopolies. France and Germany do it with strict regulation of their labor markets and a 45 to 50 percent tax burden—but they also have persistently slower growth and higher

unemployment than we do. Lind doesn't mention taxes; instead, he assumes his system can get the results he wants for workers by eliminating the market pressures for employers. Yet innovation economics has established—Robert Solow won a Nobel prize for his early work in this area—that competitive pressures are integral to the development and adoption of the innovations that ultimately raise productivity and wages. Since cartels would dampen those pressures, that leaves higher taxes to finance the promised wage and benefit gains.

Lind is right that we have big problems. Finance needs extensive new regulation. To begin with, its deregulation overlooked what economists call the "agent-principal" problem: Without regulation to constrain them, the executives, managers, and traders (the agents of the principals, who are the shareholders) found they could earn enormous short-term salaries and bonuses by taking enormous long-term risks. When those risks didn't pan out, the cartel-like concentrations in finance left the sector, and then the rest of us, vulnerable.

Lind is also right that most American workers face daunting long-term problems. In the 1990s, strong growth drove job creation, and strong productivity gains led to strong wage growth—just as modern economics predicts. That ended in the 2002-2007 expansion: Relative to growth, job creation rates fell by half, and the strongest productivity gains since the 1960s were accompanied by stagnating wages. Unless we can do something about these developments, they could spell the end of upward mobility for most Americans.

Part of the wage problem reflects changes in the economy that have little to do with regulation or concentration. For the first time ever, U.S. businesses have been investing more in the development and use of ideas and other intangible assets than in physical assets of property, plant, and equipment. Moreover, most of the value the economy now produces comes from those intangible assets. In 1984, the book value of the 150 largest U.S. companies—what their physical assets would bring on the open market—accounted for 75 percent of their stock market value; by 2005, it was equal to just 36 percent of their market capitalization. The idea-based economy has gone from metaphor to reality.

Knowing this, it's unsurprising that wage and salary gains in the 2002-2007 expansion went almost entirely to the roughly one-fifth of workers who are adept at developing and using ideas, or at least are very productive in workplaces dense with information technologies. This suggests a new social imperative: Every worker needs access to training in those technologies. As senator and candidate, Barack Obama supported a plan to provide grants to community colleges to keep their computer labs open in the evenings and weekends for any adult to walk in and receive free instruction. Obama can make that a reality.

The harder problem is posed by globalization. As globalization has produced hundreds of thousands of new competitors around the world, the competition has had the predictable effect of making it harder for companies to raise their prices. That's good news for consumers, but U.S. companies that have found it harder to raise their prices also see some of their costs rising sharply—mainly health care, energy, and pensions. Unable to pass along these higher costs in higher prices, companies cut jobs and wages.

This new dynamic suggests another new imperative: reforms to slow the rate of increase in these business costs or shift some of the burden to taxpayers (mostly that top one-fifth already doing well). Here, Obama is on the case. His health care reforms stress cost controls, and his climate agenda, if done right, could eventually bring down energy costs by expanding our sources of energy into low-carbon areas. The catch is that the early stages of these reforms will increase health care costs (to expand access) and energy costs (to force greater development and use of alternative fuels). And these early stages could take a decade.

With the economic nature of the problem clear, more innovation in both areas should be a national priority. It's not the kind of innovation that cartel regulators can command. It is the kind that a president intent on being transformative can help inspire and organize from government, universities, businesses and NGOs. This remains Barack Obama's biggest task. **D**