



Institute for
New Economic Thinking
AT THE OXFORD MARTIN SCHOOL



CAPITALISM RE-DEFINED

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Capitalism Redefined

What prosperity is, where growth comes from, why markets work—and how we resolve the tension between a prosperous world and a moral one.

For everyone but the top 1 percent of earners, the American economy is broken. Since the 1980s, there has been a widening disconnect between the lives lived by ordinary Americans and the statistics that say our prosperity is growing. Despite the setback of the Great Recession, the U.S. economy more than doubled in size during the last three decades while middle-class incomes and buying power have stagnated. Great fortunes were made while many baby boomers lost their retirement savings. Corporate profits reached record highs while social mobility reached record lows,

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Democracy, Winter 2014, www.democracyjournal.org



What is the point of economics if not to improve people's lives?

What is the point of economic policy if not to build more inclusive and harmonious societies?

What is the value of international cooperation if not to share our knowledge to raise the living standards of the most vulnerable?

Sometimes the simplest questions will generate the biggest truths!

– Angel Gurría, Secretary-General, OECD

Some simple questions

- What is capitalism for?
- How do we know if one set of economic activities are better or worse for society than another?
- How do we know if one set of public policies are better or worse for society than another?
- Can we measure these things?

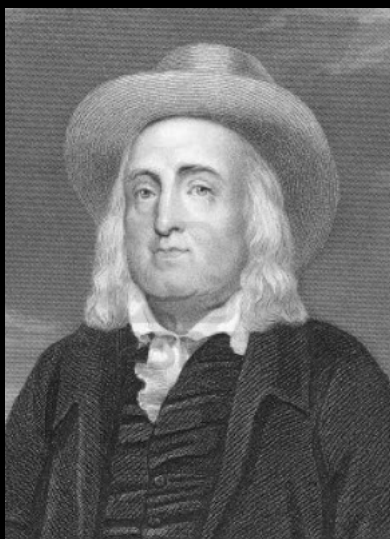
Today's discussion

- How economics has traditionally viewed these questions
- A 21st century view of capitalism
- What does it mean for policy, politics, and business?
- Can we measure true prosperity?

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Traditional economics and social welfare



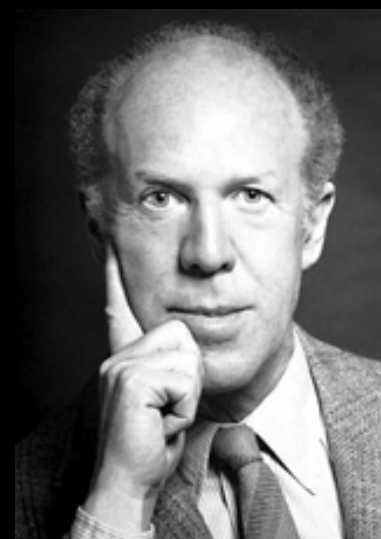
Jeremy Bentham
(1748-1832)

Individuals maximise
their utility



Vilfredo Pareto
(1848-1923)

Allocation is Pareto
efficient when no
individual's utility can
be improved without
reducing someone
else's utility

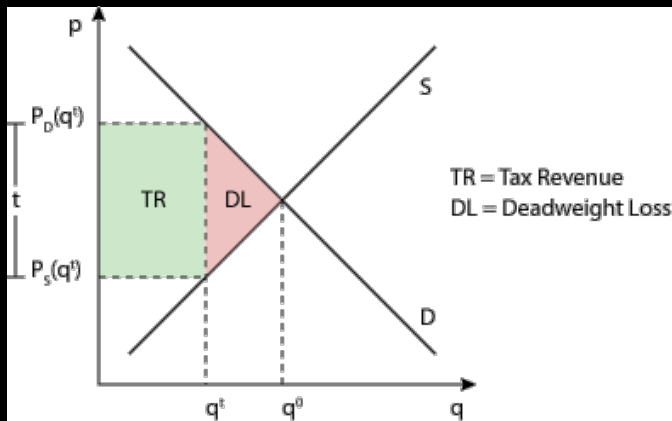


Gérard Debreu
(1921-2004)

Free markets lead to
Pareto efficient
outcomes; and any
desired Pareto
efficient outcome
can be achieved by
market mechanisms

Neoclassical theory of value underpins much public policy and political debate

Social Welfare Analysis



Source: www.econport.org

Cost-Benefit Analysis

Social value of climate action =
PV (benefits of avoided damage) -
PV (costs of action)
Discounted at societal rate

Politics



What emerges from this theory...

- Price and value are the same thing – market is the ultimate arbiter of value
- Wealth = money value of net assets
- Growth = change in GDP
- Interfering with the market always reduces social welfare, but maybe justified if benefit > cost
 - Externalities
 - Public goods
 - Monopoly/market power
 - Asymmetric information
 - Social justice arguments
- The economy we have today is in Pareto efficient equilibrium – any deviation must be bad

But what if the theory is wrong?

| Neoclassical Welfare Theory Assumptions | Real World |
|---|---|
| Individuals maximise utility, preferences convex | Utility functions are not stable; play no role in decision making |
| Individuals behave 'rationally' and deductively | Individuals behave heuristically and inductively |
| Individuals have perfect information | Individuals have highly limited and asymmetric information |
| Individuals discount the future time consistently | Individuals are time inconsistent in discounting the future |
| Time is reversible, system is ergodic | Many economic phenomena irreversible, system is non-ergodic |
| Micro adds linearly to macro | Macro emerges from non-linear micro interactions |
| Markets are complete | Markets are incomplete |
| Markets always find equilibrium | Markets can be out of equilibrium for significant periods of time |
| And so on... | |

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Knowing that
capitalism works is
not the same as
knowing how and
why it works

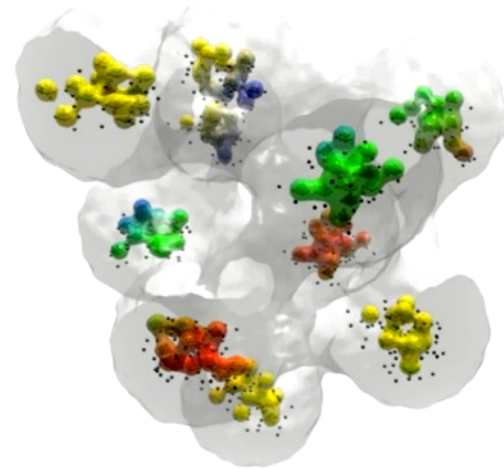


A 21st century view of economics

Economy is not a mechanical equilibrium system



Economy is a complex adaptive system



From equilibrium to realistic complexity

TRADITIONAL ECONOMICS

COMPLEXITY ECONOMICS

Dynamics

Economies are closed, static, linear systems in equilibrium

Economies are open, dynamic, non-linear systems far from equilibrium

Agents

Homogeneous agents

- Only use rational deduction
- No mistakes, no biases
- No need to learn

Heterogeneous agents

- Mix deductive/inductive decisions
- Subject to errors and biases
- Learn and adapt over time

Networks/ institutions

Assume agents interact indirectly through market mechanisms

Explicitly account for network structure of interactions and institutions

Emergence

Macro is linear adding up of micro (representative agents)

Macro patterns emerge non-linearly from micro behaviors and interactions

Evolution

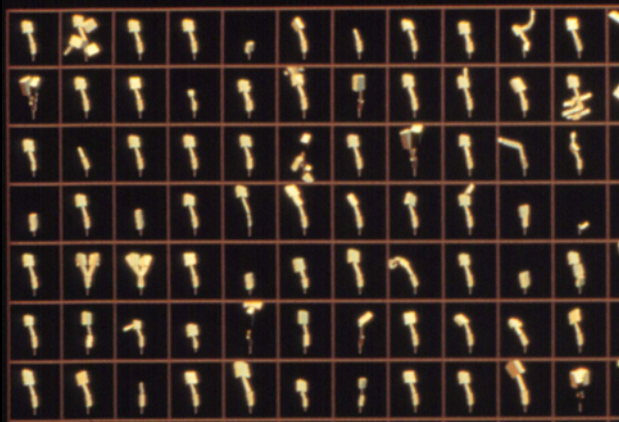
No endogenous mechanism for creating novelty or increases in economic order and complexity

Evolutionary process creates novelty and growing order and complexity over time



Capitalism is an evolutionary system

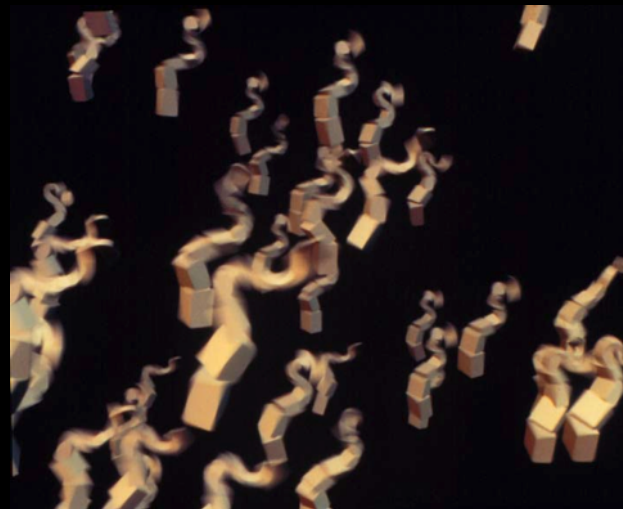
Variation



Selection

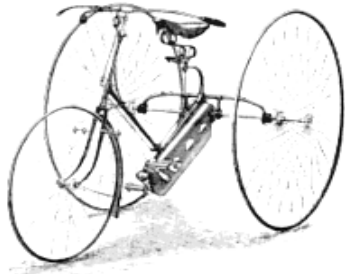


Amplification



Evolution
finds
solutions to
hard
problems

The genius of capitalism – evolving solutions



Prosperity is not money – it is accumulation of and access to solutions to human problems

Would you rather be rich here...

...or poor here



Example solutions:

- | | |
|---------------|-------------------|
| Food | • Hunt and gather |
| Shelter | • Straw hut |
| Health | • Medicine man |
| Transport | • Dugout canoe |
| Security | • Spear |
| Entertainment | • Dance |

Measured in \$
500x richer

Measured in
solutions
10 million x

- Supermarket
- Apartment
- Hospital
- Tube
- Police
- TV, internet, pub, dance

Provided by:
Market
Market/Govt
Govt/Market
Govt
Govt
Market

Real increases in prosperity

From

To widely available

Sweltering in the heat



Air-conditioning

Dying from infection



Antibiotics

Walking everywhere



Bikes, trains, cars, planes

Telegrams



Phones, email, Facebook

Going to the library



All the world's information in
your pocket

Soggy potato chip



Crispy potato chip

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Re-defining capitalism

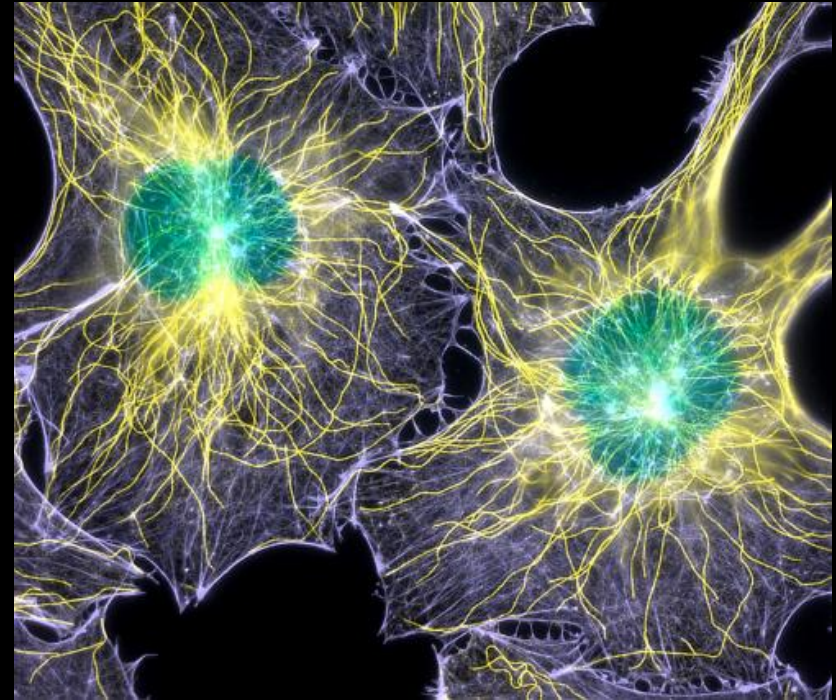
- Purpose of capitalism is to provide solutions to human problems
- Wealth is the accumulation of solutions
- Growth is the rate at which new solutions are created and made available
- Prosperity is the set of solutions plus access
- Goal of business is to create new, better, more available solutions
- Markets and governments together create an interdependent evolutionary ecosystem for solution creation and access

Re-framing political economy, externalities and rent seeking

- My solution is your problem (e.g. zoning)
- My solution is society's problem (e.g. derivatives)
- My solution today is society's problem tomorrow (e.g. obesity, climate change)
- Are you solving a real human problem? (e.g. high-frequency trading)

Markets and states are a deeply entwined ecosystem

- Economy is an ecosystem – market and state interdependent
- State provides institutional framework for market evolution
- State influences evolutionary “fitness function”
- State adjudicates “solutions vs. problems”
- Some “solutions” provided by state (public goods, social justice reasons)
- Markets provide incentives for massive experimentation, solution evolution, amplification
- Markets not efficient but highly effective at evolutionary search, solution creation and access



Market vs state debates are dead-end

Debates should be about effectiveness of the system in generating prosperity

Today's discussion

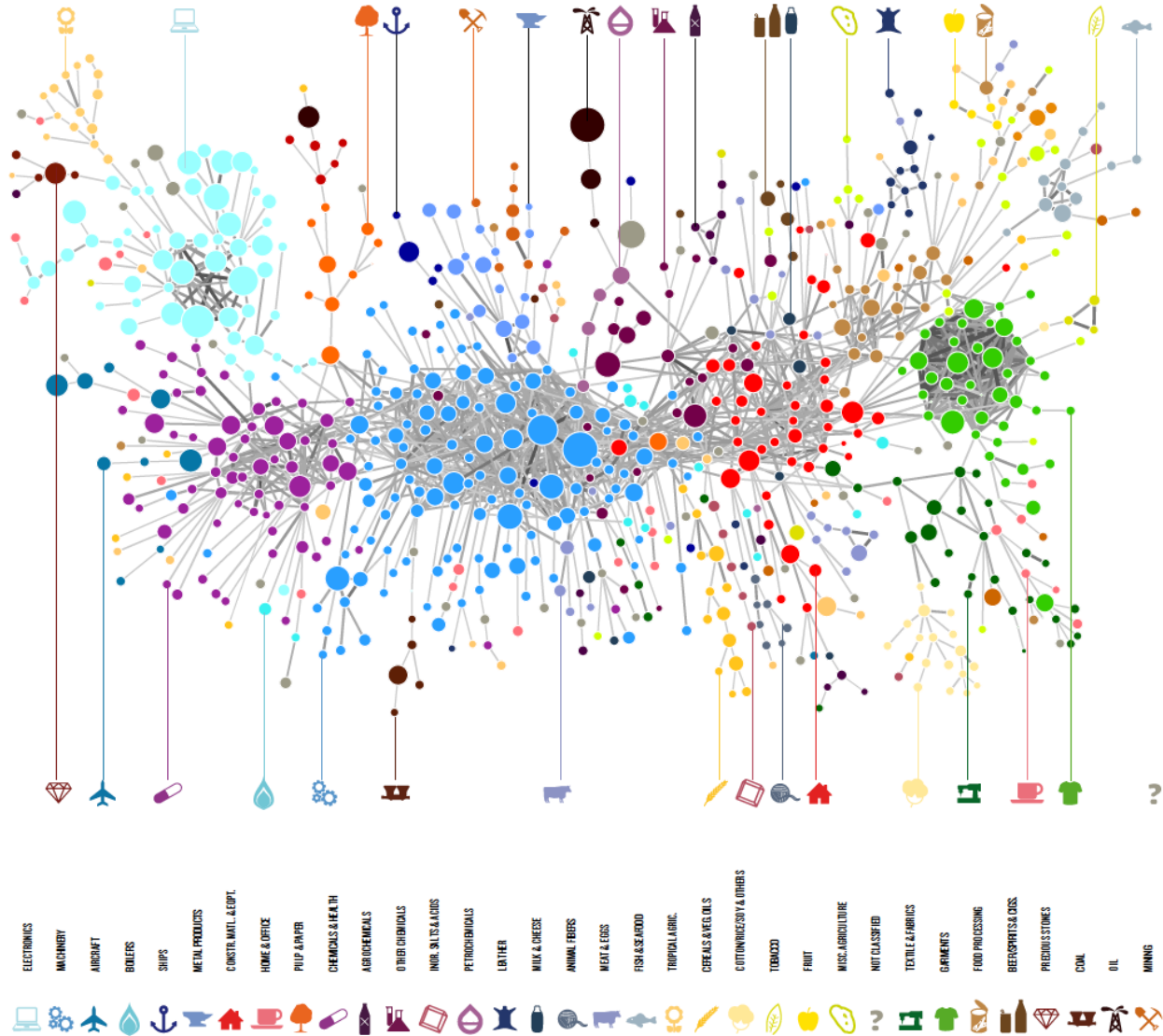
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Six concepts of “growth”

1. GDP – output measured in monetary units
2. Improved GDP – output adjusted for externalities, natural capital, unpaid labour, etc. (Stiglitz, et.al.)
3. Inclusive Growth – distribution of real disposable household income adjusted for non-monetary factors (OECD)
4. Well-being – subjective self-assessment of life satisfaction (Gross National Happiness, OECD “How’s Life?”)
5. Capabilities – freedom to achieve (Sen, HDI)
6. Prosperity – growth of and access to set of solutions to human problems – goal: measure real changes in material standard of living across population and time

Could work on “product space” of economy provide a starting point for “solution space”?

Product Space of the world economy (Hausmann, Hidalgo et. al.)



Could we measure a “basket of solutions”?

Inflation measured on basket of consumption goods



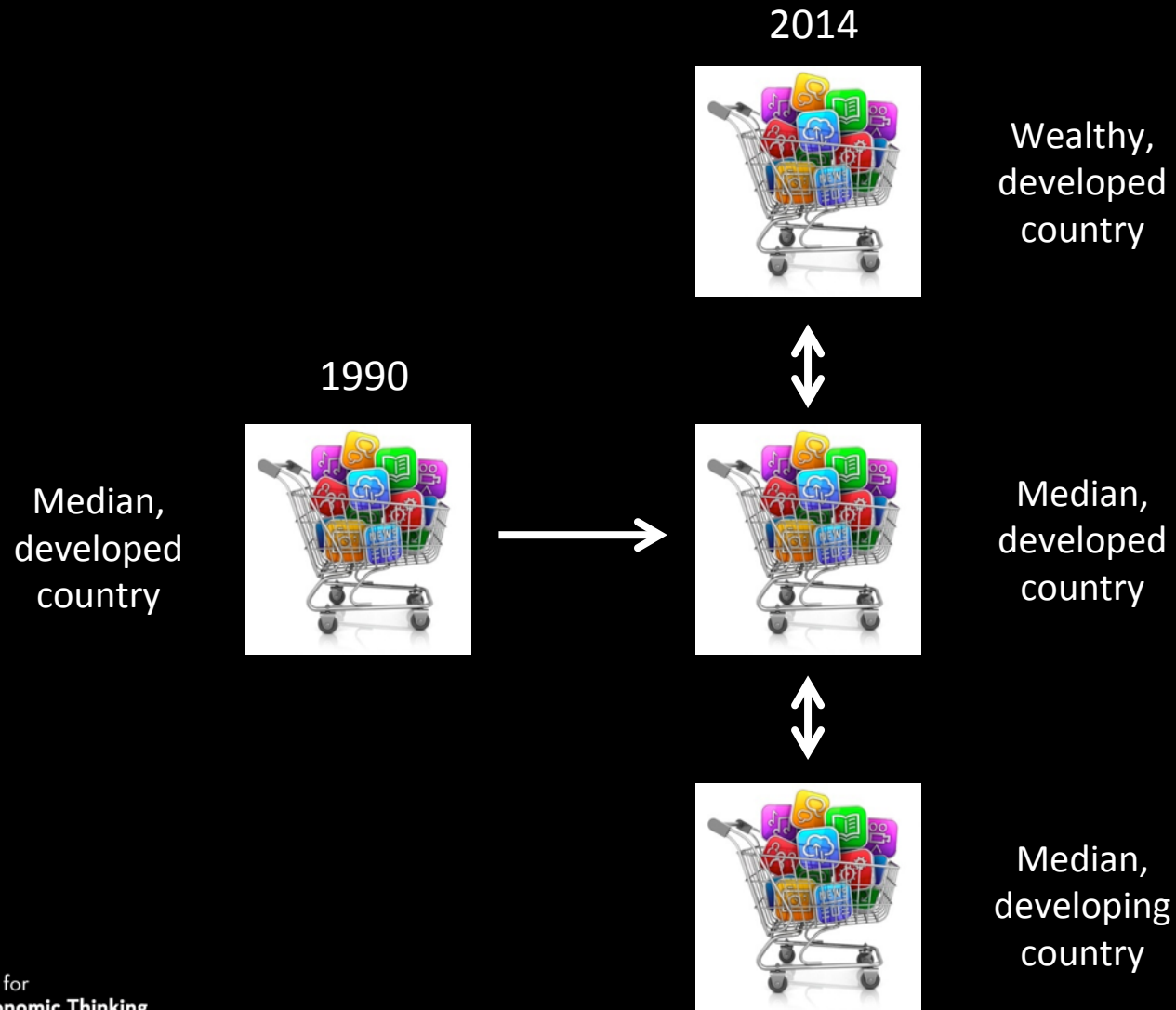
Could we measure household access to basket of solutions?



Quality, cost and access to:

- Food
- Housing
- Clothing
- Transport
- Healthcare
- Education
- Information
- Entertainment

Such “baskets of solutions” might be compared across time, households, and countries

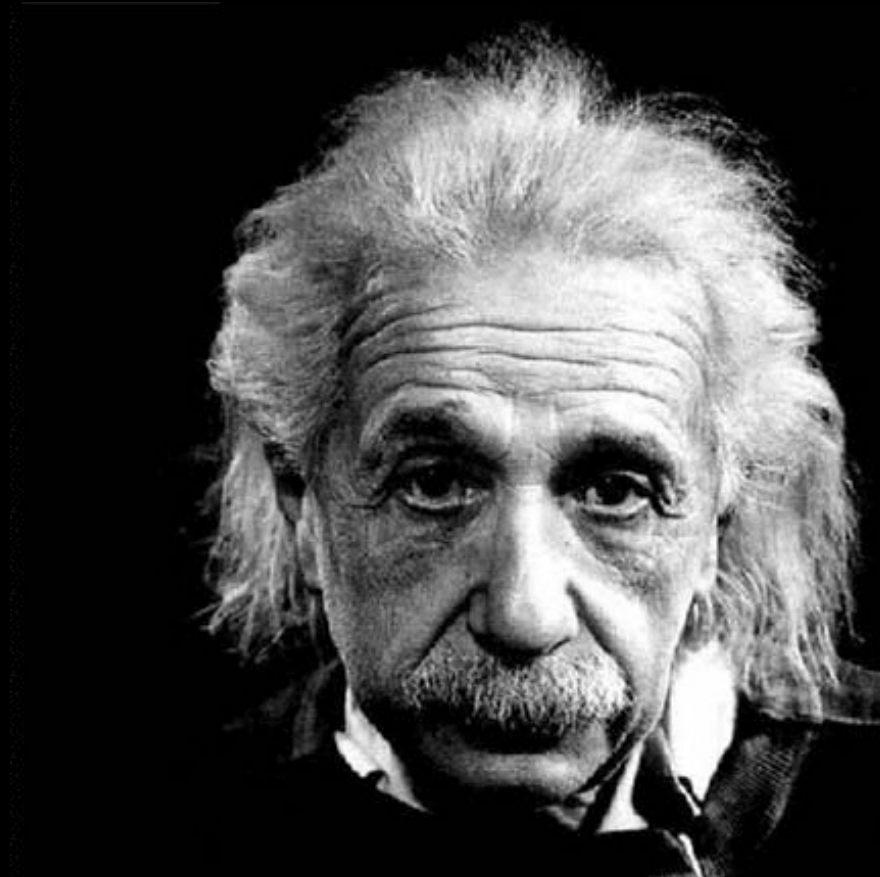


Some final speculations

- Might help better measure impact of knowledge economy (iPhone today vs. telephone in 1980s)
- Different view on “inclusiveness”
 - Median developed country households better off than income statistics indicate?
 - Gap vs. developing countries wider than PPP indicates?
- Re-frame climate/green growth debate
 - Social welfare analysis of Industrial Revolution from perspective of 1750
 - Many “solutions” today create problems tomorrow (e.g. fossil fuels)
 - New solutions to need for clean energy, sustainable use of natural capital would increase prosperity, not reduce social welfare
- Implies shift in corporate governance from shareholder value maximisation to producing solutions for customers – profits are a product of success, not purpose – many high-performing companies already run this way
- New political narrative on “problem solving”?

‘We cannot solve problems by using the same kind of thinking we used when we created them.’

ALBERT EINSTEIN



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THANK YOU

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