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Choosing your own capitalism in a globalised world?

Daron Acemoglu, James A Robinson, Thierry Verdier, 21 November 2012

Amid the current economic slowdown there is renewed interest in what type of capitalism fosters growth and best improves welfare. This column argues Nordic-style capitalism may provide higher welfare but in an interconnected world, it may be the cut-throat US capitalism, with its extant inequalities, that makes possible the existence of more cuddly Nordic societies.

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Against the background of the global financial crisis and the current economic slowdown, there is renewed interest in what type of capitalism is 'best' – which fosters growth and/or best improves average welfare in a society.

The debate between Mitt Romney and Barack Obama in the US presidential elections highlighted these choices, in essence pitting them against one another. On the one hand was the stereotypical image of US society based on unfettered competition and risk taking. On the other was an alternative conception in which the US should take steps towards a Nordic-style social democracy with greater emphasis on redistribution and social protection.

Both the US and the Nordic systems have produced prosperous countries and similar growth rates over the past 60 years[1]. Significant differences, though, exist between these societies.

- The US is richer than Denmark, Finland and Sweden[2].
- The US is also widely viewed as a more innovative economy.

It has played a leading role in many of the transformative technologies of the last several decades, partly because it provides more high-powered incentives to its entrepreneurs and workers who work longer hours, take fewer and shorter vacations, and take more risks.

- Nordic societies have much stronger safety nets, more elaborate welfare states, and more egalitarian income distributions than the US (Smeeding, 2002, Atkinson et al. 2011).

The economic success and social performance of Nordic countries raises two interrelated issues.

- First, the US path to economic growth is not the only one.

Nations appear capable of achieving prosperity without sacrificing their social welfare programs and a relatively egalitarian structure.

- Second, to the extent that more limited inequality is valued for social cohesion reasons or due to risk sharing, average welfare could easily be higher in Nordic nations despite their lower income per capita.

But if so, why don't we all try to adopt Nordic-style institutions? More generally, in an interdependent world, can we all choose the same type of capitalism and, in particular, combine dynamic capitalism with a heavy emphasis on egalitarianism and social protection?

Varieties of capitalism

One answer to this question comes from the literature on the 'varieties of capitalism' in comparative

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political economy (Hall and Soskice 2001). This literature draws a distinction between a coordinated market economy capturing salient features of Nordic countries, and a liberal market economy proxying for a US style economy.

This literature suggests that both types of economies can achieve high incomes and similar growth rates, but coordinated market economies typically have more social insurance and less inequality. A successful capitalist economy need not give up on social insurance to achieve rapid growth. Moreover, this literature also suggests that different societies have developed these arrangements for historical reasons and once established, they tend to persist (perhaps because of institutional complementarities or because of the usual difficulties of changing institutions).

Behind this analysis is an implicit view. Because economic outcomes are similar but coordinated market economies provides better social insurance to their citizens, the citizens of liberal market economies that became coordinated market economies would gain in social welfare terms. Moreover, such a switch is feasible even if the weight of history makes it non-trivial.

Asymmetric institutional choices in an interdependent world

In recent research (Acemoglu et al. 2012), we suggest that in an interconnected world, the answer may be quite different. With international economic linkages, institutional choices of different societies are also entangled. For one, countries trade and this induces specialisation. If there are some complementarities between specialisation decisions and certain institutional arrangements, the world equilibrium might be asymmetric. Some countries would choose the 'liberal' route and specialise in sectors in which this creates a comparative advantage, while others choose the coordinated route and specialise in other sectors.

Another international linkage is technological, and this is the one our research formally develops. We consider a canonical dynamic model of endogenous technological change at the world level with three basic features. First, there is technological interdependence across countries, with technological innovations by the most technologically advanced countries contributing to the world technology frontier, on which in turn other countries can build on to innovate and grow. Second, we consider that effort in innovative activities requires incentives which come as a result of differential rewards to this effort. As a consequence, a greater gap in income between successful and unsuccessful entrepreneurs increases entrepreneurial effort and thus a country's contribution to the world technology frontier. Finally, we assume that in each country the reward structure and the extent of social protection shaping work and innovation incentives is determined by (forward-looking) national social planners.

The fact that technological progress requires incentives for workers and entrepreneurs results in greater inequality and greater poverty (and a weaker safety net) for a society encouraging more intense innovation. Crucially, however in a world with technological interdependence, when one (or a small subset) of societies is at the technological frontier and contributing disproportionately to its advancement, the incentives for others to do so will be weaker. In particular, innovation incentives by economies at the world technology frontier will create higher growth by advancing the frontier, while strong innovation incentives by followers will only increase their incomes today since the world technology frontier is already being advanced by the economies at the frontier.

This logic implies that the world equilibrium with endogenous technology transfer is typically asymmetric with some countries having greater incentives to innovate than others. In such equilibrium, the technologically leading countries opt for liberal-style institutions (what we call 'cut-throat' capitalism) with high-powered incentives, little social insurance and income inequality, while other following countries adopt coordinated-style institutions (what we call 'cuddly' capitalism) as a best response to the technology leader's advancement of the world technology frontier, ensuring therefore better insurance to their population and greater equality.

We can't all be like the Nordics, can we?

The main result of this theoretical investigation is that, in the long run, all countries tend to grow at the same rate, but those with cuddly reward structures are strictly poorer. Notably, however, these countries may have higher welfare than the cut-throat leader; in fact if the initial gap between the frontier economy and the followers is small enough, the cuddly followers will necessarily have higher welfare because of the greater social insurance that their institutions provide. Thus, our

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analysis confirms the intuition that all countries may want to be like the Nordics with a more extensive safety net and a more egalitarian structure.

Yet the main implication of our theoretical framework is that we cannot all be like the Nordics! Indeed it is not an equilibrium choice for the cut-throat leader, the US, to become cuddly. As a matter of fact, given the institutional choices of other countries, if the cut-throat leader were to switch to such cuddly capitalism, this would reduce the growth rate of the entire world economy, discouraging the adoption of the more egalitarian reward structure. In contrast, followers are still happy to choose an institutional system associated to a more egalitarian reward structure. Indeed, this choice, though making them poorer, does not permanently reduce their growth rates, thanks to the positive technological externalities created by the cut-throat technology leader. This line of reasoning suggests therefore that in an interconnected world, it may be precisely the more cut-throat American society, with its extant inequalities, that makes possible the existence of more cuddly Nordic societies.

Conclusions

Our research has taken a first step towards a systematic investigation of institutional choices in an interdependent world where countries trade or create knowledge spillovers. This perspective suggests that the diversity of institutions we observe among nations may be explained not just as an outcome of policy mistakes or historical legacies, but also as the result of mutually self-reinforcing asymmetric equilibria. To make this point in the most forceful way, our analysis naturally abstracted from differences in fundamentals between nations, such as cultural differences in terms of taste for redistribution or concern for fairness. We further focused on one specific institutional dimension, i.e. the structure of rewards associated with innovation and entrepreneurship, leaving aside all the richness and complexity of clustering, path dependency and interactions of multidimensional institutional systems (including labour, product and financial market regulations, or educational and training systems). Investigating how these various facets interact with the logic of our framework is certainly worthwhile doing in future research. At the end of the day, however, whether these ideas contribute to the actual divergent institutional choices among relatively advanced nations remains largely an empirical question. We hope that this research will be an impetus for a detailed empirical study of these issues.

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1 The average growth rates of income per capita in the US, Denmark, Finland, Norway and Sweden between 1980 and 2009 are 1.59%, 1.50%, 1.94%, 2.33% and 1.56%.

2 The US had an income per capita (in purchasing power parity, 2005 dollars) of about $43,000 in 2008. Denmark’s is about $35,870, Finland’s about $33,700 and Sweden stands at $34,300 (OECD 2011). Norway, on the other hand, has higher income per capita ($48,600) than the US, but this comparison would be somewhat misleading since the higher Norwegian incomes are in large part due to oil revenues.

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