
Why Capitalism Needs Populism

By Raghuram G. Rajan *Fri, May 10, 2019*

'If voters in small-town America succumb to despair and lose hope in the market economy, they will be vulnerable to the siren song of ethnic nationalism or full-bore socialism, either of which would destroy the delicate balance between markets and the state,' writes our guest columnist.



Big Business is under attack in the United States. Amazon canceled its planned new headquarters in the New York City borough of Queens in the face of strong local opposition. Lindsey Graham, a Republican US senator for South Carolina, has raised concerns about Facebook's uncontested market position, while his Democratic Senate colleague, Elizabeth Warren of Massachusetts, has called for the company to be broken up. Warren has also introduced legislation that would reserve 40% of corporate board seats for workers.

Such proposals may seem out of place in the land of free-market capitalism, but the current debate is exactly what America needs. Throughout the country's history, it has been capitalism's critics who ensured its proper functioning, by fighting against the concentration of economic power and the political influence it confers. When a few corporations dominate an economy, they inevitably team up with the instruments of state control, producing an unholy alliance of private- and public- sector elites.

This is what has happened in Russia, which is democratic and capitalist in name only. By maintaining complete control over commodity extraction and banking, an oligarchy beholden to the Kremlin has ruled out the possibility of meaningful economic and political competition. In fact, Russia is the apotheosis of the problem that US President Dwight D. Eisenhower described in his 1961 farewell address, when he admonished Americans to "guard against the acquisition of unwarranted influence" by the "military-industrial complex" and the "potential for the disastrous rise of misplaced power."

With many US industries already dominated by a few "superstar" firms, we should be glad that "democratic socialist" activists and populist protesters are heeding Eisenhower's warning. But, unlike in Russia, where the oligarchs owe their wealth to the capture of state

assets in the 1990s, America's superstar firms have gotten to where they are because they are more productive. This means that regulatory efforts have to be more nuanced—more scalpel than sledgehammer.

Specifically, in an era of global supply chains, US corporations have benefited from enormous economies of scale, network effects, and the use of real-time data to improve performance and efficiency at all stages of the production process. A company like Amazon learns from its data constantly to minimize delivery times and improve the quality of its services. Confident of its superiority relative to the competition, the firm needs few favors from the government—one reason why Amazon founder Jeff Bezos can back *The Washington Post*, which is often critical of the US administration.

But just because superstar firms are super-efficient today does not mean they will stay that way, particularly in the absence of meaningful competition. Incumbents will always be tempted to sustain their positions through anti-competitive means. By supporting legislation such as the 1984 Computer Fraud and Abuse Act and the 1998 Digital Millennium Copyright Act, the leading Internet firms have ensured that competitors cannot plug into their platforms to benefit from user-generated network effects.

Similarly, after the 2009 financial crisis, the big banks accepted the inevitability of increased regulations, and then lobbied for rules that just so happened to raise compliance costs, thereby disadvantaging smaller competitors. And now that the Trump administration has become trigger-happy with import tariffs, well-connected firms can influence who gets protection and who bears the costs.

More generally, the more that government-defined intellectual-property rights, regulations, and tariffs—rather than productivity—bolster a corporation's profits, the more dependent it becomes on government benevolence. The only guarantee of corporate efficiency and independence tomorrow is competition today.

The pressure on the government to keep capitalism competitive, and impede its natural drift toward domination by a dependent few, typically comes from ordinary people, organizing democratically in their communities. Not possessing the influence of the elite, they often want more competition and open access. In the US, the late nineteenth century Populist movement and the early twentieth century Progressive movement were reactions to monopolization in critical industries such as railroads and banking.

These grassroots mobilizations led to regulations like the 1890 Sherman Antitrust Act, the

1933 Glass-Steagall Act (albeit less directly), and measures to improve access to education, health, credit, and business opportunities. By supporting competition, these movements not only kept capitalism vibrant, but also averted the risk of corporatist authoritarianism.

Today, as the best jobs drift to superstar firms that recruit primarily from a few prestigious universities, as small and medium-size companies find the path to growth strewn with impediments laid by dominant firms, and as economic activity abandons small towns and semi-rural communities for megacities, populism is emerging again. Politicians are scrambling to respond, but there is no guarantee that their proposals will move us in the right direction.

As the 1930s made clear, there can be much darker alternatives to the status quo. If voters in decaying French villages and small-town America succumb to despair and lose hope in the market economy, they will be vulnerable to the siren song of ethnic nationalism or full-bore socialism, either of which would destroy the delicate balance between markets and the state. That will put an end to both prosperity and democracy.

The right response is not revolution, but rebalancing. Capitalism needs top-down reforms, such as updated antitrust regulation, to ensure that industries remain efficient and open to entry, and are not monopolized. But it also needs bottom-up policies to help economically devastated communities create new opportunities and maintain their members' trust in the market economy. Populist criticism must be heeded, even if the radical proposals of populist leaders are not followed slavishly. This is essential to preserving both vibrant markets and democracy.

Raghuram G. Rajan is professor of finance at the University of Chicago Booth School of Business and the author, most recently, of [The Third Pillar: How Markets and the State Leave the Community Behind](#).