ELSEVIER

Journal of Economic Behavior & Organization
Vol. xxx (2006) xxx–xxx

JOURNAL OF
Economic Behavior
& Organization

www.elsevier.com/locate/econbase

Book review

The Battle for the Soul of Capitalism, John Bogle. Yale University Press, New Haven, CT (2005). 251 pp., index; US$ 25.00, ISBN: 00300-10990-3

Often, when I get a request to do a book review, I accept because it is a book that I wanted to read, and doing the review serves as a precommittment to get me to do something I wanted to do. In the case of John Bogle's *The Battle for the Soul of Capitalism*, that wasn't the case; when I was asked to review it, I had already read it, having been hooked by the title the first time I saw it. But I was less certain that I wanted to review it because as an academic I found the book somewhat diffuse and ephemeral—it's written by a businessman (John Bogle was founder and chief executive for the Vanguard Mutual Fund Group) for the general public, not for academics, and, as befits a popular book, it includes many strong op-ed type statements with less support than academics would prefer. Still, I was sympathetic to the ideas in the book; here was a top businessperson taking on business and capitalism with precisely the type of honest introspection that one would want in a leader, but which one so seldom sees. Moreover, here was a book that looked at the big issues that economists tend to avoid, and which fascinate me. Thus, I decided to do the review, and think more deeply about Bogle's argument.

1. Summary of the book

The structure of the book is straightforward: three parts with three chapters each, and a final part with a one-chapter conclusion. Each of the three parts looks at a specific US economic institution. Bogle asks what went wrong with it, why it went wrong, and what can be done to fix it? (It sure is nice to have a businessman writing a book—he gets right to the point; no messing around.) The three economic institutions he considers are Corporate American, Investment America, and Mutual Fund America.

Part I asks what went wrong with Corporate America. In it he argues that capitalism went wrong because it went through a pathological mutation as it evolved from "traditional owner's capitalism" to "manager's capitalism." In that process, the world of business moved from a system of trust to a "new" 'bottom line' society whose attributes include "grossly excessive executive compensation and stock options." The result has been an enormous transfer of wealth from investors (and workers, through their pension funds) to business leaders, corporate insiders, and financial intermediaries. His argument is that the diffusion of ownership of corporate America has allowed corporate managers to run companies and extract resources far in excess of what he believes is appropriate. He argues that while we are "a bottom-line society," we are focused on the "wrong bottom line:

0167-2681/$ – see front matter © 2006 Published by Elsevier B.V.
doi:10.1016/j.jebo.2006.06.003

form over substance, prestige over virtue, money over achievement, charisma over character, the ephemeral over the enduring, even mammon over God" (p. 3).

The reason corporate American went wrong is, according to Bogle, a failure of corporate governance. Our traditional gatekeepers – corporate directors, auditors, the financial community, regulators, and legislators – failed. Because they failed, owners gave up their responsibility, allowing us to move to what is almost a "dictatorship in corporate America, a system in which the power of the CEO seems virtually unfettered" (pp. 29–30).

Bogle's solution to the problem is to return corporate America to its owners. He provides seven policy recommendations: encourage corporate citizenship; clearly separate ownership from management; fix the stock options mess; focus pay on performance, not peers; return to a long-term focus; let the sunlight shine on accounting; and get a new mindset for the board.

Part II asks what went wrong with "Investment America." This question is relevant to Bogle since it is "Investment America" that has given up control. He argues that control of stock has passed from individual investors to a relatively few financial institutions, and that these institutions have changed their focus from long-term investment to short-term speculation. Financial institutions also exhibit serious conflicts of interest because they collectively own huge amounts of the shares of the very corporations to whom they are paying fees. This has allowed corporations to be run for the benefit of managers rather than for the benefit of owners. Why did investment American go wrong? Bogle's answer is that "financial institutions came to focus their investment strategies not on the intrinsic value of the corporation, but on the momentary precision of the price of its stock" (p. 69). Bogle's proposal for fixing Investment America is to move away from speculation and return to long-term investing and corporate democracy.

Part III applies the same three-part analysis to "Mutual Fund America," which Bogle sees as having played a major role in the failure of Investment America to fulfill its appropriate ownership responsibilities. He sees Mutual Fund America as a "consummate example of owners' capitalism gone awry" (p. 139). Given his background in mutual funds, his knowledge of specifics here is superb: he describes how fund operators have placed their interests ahead of fund owners' interests, which has resulted in low long-term returns earned by the funds compared to the returns in the stock market. He describes how the funds have elevated salesmanship over stewardship, and have engaged in risky investment policies, which have served primarily to create short-term gains. To fix the problem Bogle believes we need a federal standard of fiduciary duty for fund directors; we also need to instill in private investors the "information, knowledge, and wisdom that will enable them to look after their own economic interests" (p. 140).

Part IV sums up his arguments and speculates about the future of capitalism. It calls for a federal commission to undertake a sweeping examination of both the displacement of direct ownership by agency ownership and the faltering state of our nation's retirement system (p. 215).

2. Discussion

There's much to like about the book, and I have no hesitation in agreeing with many of the author's specific arguments; I share with Bogle the moral outrage and concern about what has happened in corporate and financial institutions. Would that we had managers who cared about long-term value. Would that we had an institutional structure that limited the amount of managerial transfers of income to insiders. I also agree that the level of CEO pay is an a priori argument for the existence of serious problems with the political economic structure of our economy. Finally, I would agree with just about all of Bogle's policy recommendations (except the ones for establishing new commissions—I'm not all that high on commissions as a way of getting anything done).

Despite all our agreement, I am unconvinced by the basic argument of the book. For Bogle, owner capitalism is the gold standard of economic institutions. He believes that if only we can get back to owner capitalism, the economy will right itself, and all will be well. I don't see it that way. Nothing in economic theory tells us that, as a functioning system, owner capitalism is the best system, or even that it is a system that works. True, we economists have developed models of how a system of profit maximizing firms has certain advantageous characteristics, but these models are far from reality. They have no entrepreneurs, no dynamics, no institutional structure, no technological change, and no endogenous property rights, all of which are central components of our economic reality. Thus, economists' theoretical models provide little guidance as to what works in practice. Economic theory is not, and was never meant to be, an argument for the economic system that we call capitalism.

The argument supporting the economic system that is called capitalism is historical, not theoretical. Capitalism is worth having as an economic system because in the past it has worked better than other systems, and because it has adapted to changing technologies and situations. It has survived with varying degrees of government interaction, and is better called pragmatism than capitalism. In a pragmatic system you have no theoretical reference point for what is the "ideal" system. A pragmatic system can only be judged in reference to other working systems. To judge it relative to the past, you have to ask what was it about the earlier system that made it work, and what has changed now.

In my view, what has fundamentally changed is not the development of managerial capitalism; that simply affects which elite gets the rent. In my view what has changed are technology and the global political environment. Specifically, technological changes, especially in financial markets, have made accumulating rent by a few via financial means much easier, and global political changes have reduced pressure on decision makers to maintain equality in the income distribution as an element of a fair system.

Previously, the accumulation of wealth by the few, which would have undermined the social stability of society, was kept in political check by the specter of communism—the fear that if the leaders did not share that wealth, the people would revolt, and take it away from them, either through democratic or revolutionary means. Democracy, social pressures, and the specter of communism placed limits on what the elite could extract. That pressure is now gone, at least temporarily, and what we have is an enormous shift in wealth to an elite. (It was previously said that once communism takes over the world, it would have to keep a capitalist country in existence to establish relative prices; it seems that the corollary to that is that capitalism needs at least the threat of communism to be a sustainably fair system.)

Eventually, I suspect, that recent shift in wealth will provoke a political reaction. The question is whether our economic system can evolve to accommodate the redistribution of income that eventually will be demanded, without undermining the stability of the system. Only time will tell.

The unstable element of our system is the combination of civic-mindedness and selfishness that is required in it. Ours is a system in which leaders must be relied upon to do what is good for society, and not themselves in a narrow sense. It is a system in which civic duty must enforce a limit on pure selfishness. It is a system in which leaders must be willing to leave something on the table, even though it was there for the taking. Bogle recognizes this, and points out that early British capitalists were civic-minded Quakers who conducted business in a civil way and who did not take advantage of all the rent-seeking possibilities open to them. His complaint, it seems to me, is that that civic mindedness did not last. But in my view the same forces that are pushing the economy today would be operating on, and did operate on, owner capitalism. Owner capitalism was unstable—for precisely the reasons Marx said: too much accumulation of wealth among the few is ultimately incompatible with social stability. Marx was wrong, however, about the future of capitalism. Revolutionary overthrow was not its fate; adaptation was. With the threat of communism incentivizing our leaders, regulations, progressive taxes, and social limitations on owners' actions allowed our pragmatic economic system to survive.

What's changed now is the threat of communism. Given the evaporation of that alternative, the constraints requiring civic mindedness have been loosened. If Bogle's solution – going back to owner capitalism – will not save capitalism's soul, what will? That's a hard question that should be high on economists' and policy makers' agendas.

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10 June 2006