Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity, William J. Baumol, Robert E. Litan and Carl J. Schramm. Yale University Press, 2007, pp. 321.

The rise of "capitalist entrepreneurship" has been gaining momentum for the past three decades, or so. It is more than about economics, politics, and the rule of law - or even culture. Perhaps more aptly it is a synergy of all three. More specifically, it's a type of capitalism where entrepreneurs, who continue to provide radical ideas that meet the test of the marketplace, play a central role in the system. It is also a sign of the times, reflecting a profound blend of the newest technological achievements and oldest human habits: basic needs and not so basic wants.

Arguably, capitalism has been evolving for centuries. It has taken many shapes and forms - good and not so very good. ("Capitalism can bring the best in products and the worst in people" – went one popular ditty.) Just to capture its ever changing and evolving nature alone would require volumes.

Yet, confronting a seemingly impossible task of scrutinizing the diverse nature of capitalism, the authors contend that the answers to such diversity of our current age can be best found by addressing the elements of a capitalist entrepreneurial economy. It may come as no surprise to find that these authors boast the values and benefits of entrepreneurship: Baumol is director of the Kaufman funded Entrepreneurial Center at the NYU and the two other authors are senior executives at the two-billion dollar Kaufman Foundation of Entrepreneurship.

The premise of the book is that strong economic growth is vital to our future -- and capitalism is the engine of that growth. This is nothing new, of course. But many people make a mistake believing that "capitalist system" is a monolith. The authors however refute that myth, describing four different varieties of capitalism. This is the significant contribution in this work. They analyze how countries, which emulate the American model, can become adaptive to constant changes and new challenges, thereby enabling rapid moves toward new economic opportunities.

The more narrow definition of modern entrepreneurship can be traced back to Schumpeter's vision of a business hero who creates, destroys, innovates and expands the economic growth by a right mix of cooperation, vision and synergy. Peter Drucker used to say that business theory, or entrepreneurial principles are easy, but what is more difficult is the practice of it. Schumpeter and Drucker defined the entrepreneur as someone who "upsets the equilibrium…who innovates." Baumol carries this idea further. He states that: "innovation is the specific instrument of entrepreneurship." Baumol, who is a leading expert in the field, describes entrepreneurship as "the bold and imaginative deviator from established business patterns and practices." Perhaps an even more succinct definition was provided by Howard Stevenson, a pioneer thinker on entrepreneurship at the Harvard Business School, who considered it as "the pursuit of opportunity beyond the resources you control." In these views we can notice a distinction between "replicative" and "innovative" entrepreneurship.

The real contribution of the Good Capitalism, Bad Capitalism is, then, the extensive discussion of "entrepreneurial capitalism." Early on, in the preface of the book, the authors note:

"Something new was afoot, and to one of us, it was sufficiently important to merit a special label: 'entrepreneurial capitalism'. This apparently new form of capitalism differed from its counterparts in other countries, especially in Japan and continental Europe, where radical entrepreneurship was noticeably absent and where a combination of large enterprises, often championed by their governments, and small retail or 'mom and pop' shops dominated the economy."

Along the way in their discussion of entrepreneurial capitalism, the authors address the age-old economic question of why some market economies prosper and others stagnate - or even decline. These questions have been explored historically, scientifically and comparatively ever since Adam Smith wrote his seminal work in 1776. Most recently, new books by David S Landes in The Wealth and Poverty of Nations -Why Some Are So Rich and Some So Poor, Jared Diamond in Collapse: How Societies Choose to Fail or Succeed, and William Easterly Elusive Quest for Growth, and White Man's Burden. Smith, Landes, Easterly and Diamond sought socio-economic, cultural and geographical explanations for secrets of growth and prosperity.

In Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity, the authors have identified four models of capitalist economy. The book comprises eight chapters. It begins with: "Entrepreneurship and Growth - A Missing Piece of the Puzzle", followed by explaining "Why Economic Growth Matters" and "What Drives Economic Growth." The remaining chapters describe different types of capitalism and what unleashes entrepreneurship. The last chapter culminates in describing the care and maintenance of entrepreneurial capitalism.

The first model is capitalism guided by the state -- otherwise known as mercantilist capitalism. This model has been favored in Asian countries, where the state controls the banks and other financial institutions. The states underwrite low wage export oriented businesses to produce goods primarily for the world market. The problem with this kind of practice is that governments tend to over invest in favored industries and underinvest in those needed for their domestic use. State-guided capitalism describes economies where growth is a central economic objective (as it is in the other two forms of capitalism), but attempts to achieve it by favoring specific firms or industries. Governments allocate credit, through direct bank ownership or by guiding credit decisions by privately owned banks, provide direct subsidies, tax incentives, grant trade protection, or use other regulatory devices in an attempt to pick winners.

Second, there is oligarchic capitalism. This is when a wealthy elite uses the state as its own domain. This was the case of Russia shortly after the fall of the Soviet Union. However, the oligarchs are now in retreat. Russia's Putin managed to move the country toward state-guided capitalism. Both of these models can work for a certain period of time. The oligarchic capitalism is not agile enough to sustain long-term growth and prosperity. (Though Russia, with its huge amounts of natural resources, can probably extend it for some time.) Southeast Asian economies have demonstrated also great success with state guidance and, until the late 1990s, there were calls in the United States to emulate their practices. But the weakness of state guidance is that once such economies near the production-possibility frontier, policymakers run out of industries and technologies to copy. When government officials rather than markets try to choose the next winners, they run a great risk of choosing the wrong industries, or channeling too much investment — and thus excess capacity — into existing sectors. Such a tendency contributed significantly to the Asian financial crisis of 1997-98, contend the authors.

Third, there is big-firm capitalism. This was the model used by Japan and Europe during the postwar era. Big firms can produce solid growth for many years, but as they mature they tend to settle for the status quo and rarely do they produce innovation or breakthrough technologies that foster dynamic growth. Big firms, or managerial capitalism, characterizes economies where large firms, some national champions, dominate production and employment. Smaller enterprises exist, but are typically retail or service establishments with one or only a few employees. Firms become large by exploiting economies of scale, improving and mass-producing the innovations developed by entrepreneurs. Western European economies and Japan are leading examples of managerial capitalism, which, like state guidance, also has delivered strong economic performance. But managerial capitalism, too, has its limits. Bureaucratic enterprises are typically averse to taking big risks, that is, developing and commercializing the radical innovations that generate large sustained jumps in productivity and thus in economic growth.

Last, there is entrepreneurial capitalism. This, ever evolving and constantly “work in progress” system is clearly the authors' choice. Some of the greatest break-throughs in inventions technology are usually brought to market by individuals, or small firms. This type of organization - free of the constraints of big firms - is better at creating new markets and opportunities and new solutions to old problems. Economies in which dynamism comes from new firms have historically commercialized the radical innovations. Examples from the last two centuries include products and innovations as railroads, automobiles, airplanes, telephones, radio, television, and the various technologies responsible for the information revolution, including both personal and mini computers, mobile devices, and software that operates them.

Most countries practice a combination of the above four models. According to the authors, the US is more successful because it is a blend of big firm and entrepreneurial capitalism, arguably the optimal combination. Many countries have entrepreneurs with grandiose ideas, but lack the capital and infrastructure to realize their goals. The entrepreneurial capitalists in the US enjoy the financial, legal, and educational framework that is needed.

The authors also point out that the US may be in danger of losing its edge due to increased regulation and risk-aversion. They argue that we must not only keep the right balance of big firms and small firms, but also maintain a conducive regulatory environment to keep the economy prosperous and growing. Although much of this material is not new, the authors' presentation of it is very orderly and refreshing.

An interesting argument why the richest nations prosper while poorer nations lag behind might be because of their relative ability or inability to exploit science, technology and economic opportunity. In every case, from ancient China to modern Japan and modern America, this is largely the result of attitudes about a myriad of factors. How did China, years ahead of Europe in technology and exploration, lose its advantage three centuries ago to become a trailblazer more recently? Why have Latin America, the Middle East, and sub-Saharan Africa lagged behind more developed nations? Would entrepreneurial capitalism give all the answers?

To be sure, no economy can realize its full potential only by having entrepreneurial firms. The optimal mix of firms contains a healthy dose of large enterprises, which have the financial and human resources to refine and mass-produce radical innovations, along with newer firms. It required Boeing and other large aircraft manufacturers, for example, to commercialize what the

Wright Brothers pioneered, or Henry Ford to mass-produce the automobile. But without entrepreneurs, few of the really bold innovations that have shaped our modern economy and our lives would be in place.

The challenge, then, for all economies seeking to maximize their growth potential is to find the right mix of managerial and entrepreneurial capitalism. Economies where entrepreneurs now flourish must not become complacent. State-guided economies can continue their rapid growth path, but ultimately they will need to make a transition to a suitable blend of the other two forms of "good capitalism" if they want to continue rapid growth. India and China, each in its own way, are already moving in this direction. The hardest challenge will be for economies entangled in oligarchic capitalism to accomplish a similar transition.

China seems to fit a quintessential state-guided economy. In this model, the central government allocates investments, through the country's state-owned banks to favored enterprises in selected industries. Also, there are sectors of the Chinese economy such as energy and agriculture that are directly managed or owned by the government and continue to be centrally planned.

In light of the above, the leaders in China have managed for the last two decades to introduce and promote entrepreneurial activities, in an economy that is officially considered as centrally planned with entrepreneurial elements. Authors seem to marvel at the Chinese case: they state that the country has been able to advance in spite of not having two necessary ingredients for a successful entrepreneurial economy, namely: effectively enforced property rights, and a financial system that affords entrepreneurs access to capital to finance their ventures. The Chinese legal system is still a work in progress. The formal financial institutions do not like to lend to new ventures, but rather to state owned enterprises. As a result, Chinese entrepreneurs typically borrow from informal lenders as investors (including families and friends) to back their enterprises.

The three authors predict limits to the informal (and ineffective laws) and financing methods. The country will have to eventually develop more formal ways of doing business. More and more investors have demanded greater formality. As more and more Chinese firms are doing business with them, formal law and finance should gradually extend to the rest of Chinese enterprise. The life of informal firms may then face its extinction, at some future point.

"Virtually all of the countries where it is easiest to start a business are developed, but all of the countries where it is most difficult are still developing if not very poor." The authors note that the gap between the rich and poor countries has widened (citing the World Bank's Doing Business Report) they document that as barriers to conducting business come down, informal firms no longer need to hide from the government and to grow to more efficient sizes. As formally registered, they pay taxes and fund government programs. So it is in the interest of authorities and the society to make it easiest for entrepreneurs to do business. Since growth occurs primarily through trade this helps in part to explain the case of China.

Even though China has lacked for a long time a formal legal system - it has been able to grow rapidly over the several last decades. The authors also point out that the Chinese leaders are adapting and learning to narrow the gap between the party and the society in an effort to build a trust, which serves as a substitute for law. But rule of law provides confidence and comfort in contract enforcement. This is why China in joining the World Trade Organization (WTO) not only had to formalize and streamline its legal system – but also developed foreign investment legal institutions that reasonably protect both parties in enforcing contracts and property rights. As a part of conditionality for China's joining WTO, China agreed to privatize its large state-owned banks. And as a positive step it is showing improvement in having an access to capital. There is progress in privatizing state owned banks. State owned banks in China still account for well over three fourth of all banking assets, yet this share shows a tendency to decline.

In oligarchic capitalism, prevalent in parts of Latin America and the Arab Middle East, power and wealth are held by a few, and economies are organized to make them, not the general populace, richer. This approach has little to recommend. "At its best, it generates sufficiently large cash flows to finance...continuing, incremental improvements in products and services," the authors write. "At its worst, big-firm capitalism can be sclerotic, reluctant to innovate, and resistant to change."

Given the Kauffman Foundation's mission to promote entrepreneurship, it is small surprise that Baumol, Litan and Schramm conclude the "best form of capitalism" blends elements of the entrepreneurial and big-firm strains. An entrepreneurial society is going to be more of a high-risk society.

In conclusion, the book is a useful survey of dominant types and trends, offering conclusions that can be supported by the evidence available. One criticism, however, is that while the book addresses the elements of capitalism in the furtherance of economic growth, the authors choose not to expand on how competing mores and institutional biases have weakened the historical bases of economic growth. The capitalist society thrives on trust, norms and enlightened self-interest. When mores are strong, laws are unnecessary; when mores are weak, laws are unenforceable.

However, this criticism may be a quibble. According to the British weekly *The Economist:* Good Capitalism, Bad Capitalism helpfully moves the debate on from competing national models to the underlying structures that shape the relative effectiveness of different sorts of capitalism." No doubt the book is well worth reading not only by academics, but also by policy-makers and an inquisitive public wanting to learn about the complex and ever evolving capitalist market economy.

About the authors: William Baumol is a professor of economics and director of the Berkeley Entrepreneurship Center at New York University. Robert E. Litan is vice president for research and policy at the Kauffman Foundation and a senior fellow in the Economic Studies and Global Economics Programs at the Brookings Institution. Carl Schramm is CEO and president of the Kauffman Foundation and a Batten Fellow at the Darden School of Business, the University of Virginia.