Rethinking Capitalism

The Rethinking Capital Foundation is reimagining modern capitalism.

Democratic societies are grappling with how to address the shortcomings of capitalism in order to build more resilient, sustainable economies. The economic principles, accounting practices and banking protocols that surround and mobilise the value in capital need to evolve to reflect wealth creation in the modern era. Reforms are needed in all areas of our institutional system to account for new classes of assets, value and risk; to distribute value more appropriately in modern society; and to reward value-generation behaviors over value-extraction behaviors.

We focus on the root causes of dysfunction in modern capitalism to identify how to align the capitalist system with 21st century expectations – society's rapidly evolving norms, values and sensibilities – i.e., a normative reset of capitalism.

The state of modern capitalism

At the core of economic thought there's an institutional over focus on market exchange processes and an under appreciation of capital, what it is, how it changes and how, in the digital world it is driving value creation. The most dramatic expression of this is the paradigm shift taking place in modern capitalism; the digital networked version of capitalism has evolved far beyond the industrial-era model.

For many decades, investors have been valuing opportunities and channeling resources based on a financial reporting framework that recognises only industrial-era assets, even though value creation has changed dramatically.

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What is capitalism?

The faults of the present lie not with Capitalism per se. Capital as an institution is a social good.
Capital allows human enterprise and other forms of value to be identified, quantified and stored. The institutional infrastructure that supports capital allows that value (stored in accounting grade assets) to be owned independently and leveraged – monetised and invested productively for individual, corporate and social purposes.

History has many important lessons to teach us, but the most important lesson of all is this: capitalism begins with an initial act of social cooperation, the agreement to recognise and legitimise an individual's ownership of something of value. In other words, capitalism becomes possible in society when we learn to capture and store economic value in institutional vessels that we know as assets and then permit individuals to command that property in their own interests. Markets although necessary, are not causal agents of capitalism. Markets evolve and market forces grow as a consequence of growth in property ownership.

Capitalism is neither a static concept nor simply a set of fixed institutions – it is a turbulent historical flow.
Western capitalism has evolved through a series of changes in its underlying 'engine of growth' – with accompanying asset revolutions – beginning with the rise of trade and the introduction of a new suite of mercantile assets in the 16th century.

Comparing industrial and digital economies.

	Industrial Economy	Networked Digital Economy
Productive Engine	Mechanical, factory based	Digital, network-based
Capital Framework	Three Capitals: 'Real' capital, financial capital and (limited) forms of natural capital	Six capitals, the three traditional forms of capital, plus human-creative capital, intellectual capital and social and relational capital (networks)
Principal Assets	Plant, equipment and machinery	Human-creative, intellectual, relational capital assets (networks)
Financial Statements (purpose)	Standardised reporting, comparability, useful for external parties, investors, bankers and other creditors	Commercial reality, useful for internal management purpose as well as external stakeholders
Governing Orthodoxy	Neoliberal Economics	Normative Economics

Capitalism 1.0: Mercantilism

Economically the religious cataclysm of the 16^{th} century helped unravel the Roman Church's restrictions on trade, and fully launch the commercial revolution. In what was to become a predictable pattern, the economy changed first and dramatically, transitioning from a closed feudal agricultural economy to a dynamic trading regime. Economic historians describe this revolutionary leap as the rise of mercantilism.
New ways of making money through trade generated a new economy, and in time initiated new forms of capital. Institutionally, medieval bankers, accountants and investors had to reinvent themselves. In the process they defined a new suite of mercantile assets, utilising the recently introduced concepts of Arabic numerals and double-entry bookkeeping.

Banks, in particular, had to change. They had largely been 'name' lenders in the feudal era, recognising bankable security only in the landed estates of the nobility. With the rise of trade and mercantile collateral, banks were able to open direct capital channels to traders. The Medici bank led the way; operating out of their home base in Florence, it launched a new merchant banking method, securing their loans on the tradable commodities of merchants. The impact was profound; surging capitalism soon blossomed into the power and glory of the Italian Renaissance.

Capitalism 2.0: Industrial Revolution

Industrialism, the second major asset revolution in western capitalism occurred the 18^{th} and 19^{th} centuries. Once again, the economy changed first, transitioning from its home-based domestic system to a mechanised factory based industrial economy. Economic historians describe this revolutionary leap as the industrial revolution. Soon, a new institutional infrastructure emerged. Accounting changes included designing new (i.e., our present) asset classes in plant, equipment, and machinery as well as new industrial-oriented cost accounting standards and procedures.

It was another banker, J.P. Morgan who played the pivotal role in this transformation. Morgan saw further into the future than his contemporaries. He was one of the first to realise that the many factories being built throughout the country needed railroads – the new distribution system for industrially produced goods – to get their products to market. Therefore, successful railroads were not only valuable in their own right, but the key to profitability of the entire industrial economy. Unfortunately, the railroad business was a mess, threatening that economic future. Morgan set out to repair this mess, and repair it he did.

With the considerable resources of the London bond markets behind him, he acquired and merged railroads across the United States and in the process began identifying, capitalising and recording the newer industrial-class assets into financial reporting and banking protocols. Soon new banking business models were devised with more advanced and efficient market institutions of all kinds. All these institutional reforms, undertaken quietly behind the scenes, were needed to sustain and finance industrial capitalism, with its new factory-based engines of growth.

Capitalism 3.0: Digital Revolution

Central to value creation of all companies today are a host of new capital forms that are generating revenues from intellectual capital such as software and design assets and/or network assets that support social media apps, and not least, big data. Computing power combined with other intangible forms of capital (inputs, stock and outputs,) dominate this new stage of capitalism.

These new capital forms are generating wealth in different ways, reversing or jettisoning core neoclassical economic assumptions. Production, for example, is no longer confined to centralised factories employing physical capital (tangible assets). Intangible forms of capital, particularly data and network-based assets, are shattering the corporate veneer and decentralising production while creating a productive engine that defies the laws of scarcity. Modern digital production does not rely upon increased mechanisation, rather it employs large amounts of service-like inputs to the distributive generation of intangible outputs that are difficult to measure and that are often exchanged on the Internet beyond the scrutiny and jurisdiction of national governments. Not surprisingly, intangibles lie at the heart of the artificial intelligence revolution and the vast revenue growth for digital giants like Google and Facebook.

As Jonathan Haskel and Stian Westlake point out in their book, Capitalism without Capital: The Rise of the Intangible Economy:

> "*Early in the 21st century, a quiet revolution occurred. For the first time, the major developed economies began to invest more in intangible assets, like design, branding, R&D [research & development], or software, than in tangible assets, like machinery, buildings, and computers. For all sorts of businesses…the ability to deploy assets that one can neither see nor touch is increasingly the main source of long-term success.*" [1]

Normative reset for modern capitalism

Rethinking Capital takes the view that we must both widen the area of economic analysis to include externalities (embracing the whole field of capitalism), and re-orient the central focus of economic analysis from market exchange processes to capital. Fortunately, the past provides us with models of change that can be employed to accomplish a normative reset with the least possible disruption.

Like conventional economics, normative theory begins with the premise that capitalism is founded in the private ownership of property. However, given that both the own-able 'things of value' and the legal institutions that provide individuals title to property are social in their origins. Society, and its changing norms, values, and interests, are both the starting point and strategic goal of normative economic study.

Fully addressing the ownership of property helps address the social responsibilities of capital. The miracle of capitalism – and its attractiveness – is that individuals can personally command the trinity of power, privilege and responsibility that is embodied in capital. However, with these privileges comes accountability; ownership of property is a kind of stewardship, which – by definition – contains a duty of care to society.

Whereas industrial era value creation was largely a mechanical phenomenon, normative focuses on the human and creative parts of the economy, the side of capitalism that drives value from human creativity, and continually improves human capital for the betterment of society.

Capitalism has been the vehicle that has elevated humanity out of poverty and created the win-win relationships that generate real value. It needs constant attention and at the moment needs major reforms to accomplish the 21st century goal of building a more just, prosperous and sustainable world.

References and notes

[1] Haskel, J and Westlake, S. Capitalism without Capital: The Rise of the Intangible Economy. Princeton: Princeton University Press, 2018