Transcript: Capitalism Versus Open Society

The following is a transcript of a lecture given by George Soros at Central European University on October 29, 2009.

Today I want to explore the conflict between capitalism and open society, market values and social values. I am going to approach the subject indirectly, by first introducing a phenomenon that has attracted my attention only recently, but has assumed such importance in my thinking that I could almost call it the fourth pillar of my conceptual framework. That phenomenon is the principal-agent problem.

Agents are supposed to represent the interests of their principals, but in fact, they tend to put their own interests ahead of the interests of those whom they are supposed to represent. That is the agency problem.

It has been extensively analyzed by economists, but they look at it exclusively in terms of contracts and incentives and they largely disregard questions of ethics and values. Yet if you leave out ethical considerations the problem becomes pretty well intractable. Values like honesty and integrity lose their grip on people's behavior and people become increasingly motivated by economic incentives.

By claiming to be value free, market fundamentalism has actually undermined moral values.

Markets are supposed to be guided by an invisible hand; that is what makes them so efficient. Participants need to exercise no moral judgments in reaching their buy and sell decisions because their actions are not supposed to have any visible influence on market prices.

In truth, the rules governing financial markets are decided by the visible hand of politicians and in a representative democracy politicians run into an agency problem.

Thus, the agency problem poses grave difficulties both for representative democracy and the market economy which cannot be resolved without an appeal to moral principles. That is how the agency problem has gained such prominence in my thinking. First, I will analyze the agency problem and then, I will deal with the conflict between capitalism and open society.

Let me start at the beginning.

I first encountered the agency problem in connection with the so-called resource curse. By resource curse I mean that countries that are rich in natural resources are often cursed with corrupt or repressive governments, insurrections, and civil wars so that the people are even poorer and lead more miserable lives than in countries that are less well-endowed by nature. Think of the Congo, Sudan, Sierra Leone, and Liberia.

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One of the nongovernmental organizations I support, Global Witness, proposed a campaign based on the slogan "Publish What You Pay." The idea was to get oil companies and mining companies to disclose the payments they make to various governments. The amounts could then be added up and the governments could be held accountable by the people for the monies they received.

The campaign was launched in 2002 and it has had an interesting history. The idea itself turned out to be a fertile fallacy because, while public opinion could put enough pressure on the big oil companies, fly-by-night operators and companies domiciled in nondemocratic states were less susceptible. So the amounts could not be added up.

Fortunately, the British government took up the cause and formed the Extractive Industries Transparency Initiative, which brought together governments, companies, and civil society in an effort to establish international standards of transparency which apply both to companies and to governments. In those countries that subscribed to the transparency initiative, the governments undertook to publish the amounts they received. That is actually working in countries like Nigeria and Azerbaijan.

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In analyzing the resource curse, I came to attribute great importance to what I called an asymmetric agency problem. According to the modern concept of sovereignty, the natural resources of a country belong to the people of that country, but governments, which are supposed to be agents of the people, put their own interests ahead of the interests of the people whom they are supposed to represent and engage in all sorts of corrupt practices. On the opposite side, the managements of the international oil and mining companies represent the interests of the companies all too well. They used to go so far as to bribe governments in order to obtain concessions. Willing takers and givers of bribes are the root cause of the resource curse.

Once I became aware of the agency problem, I discovered it everywhere.

Communism failed because of the agency problem. Karl Marx's proposition-from everybody according to their ability and to everybody according to their needs-was a very attractive idea, but the communist rulers put their own interests ahead of the interests of the people.

The agency problem is also the bane of representative democracy: the elected representatives use their powers for their own interests to the detriment of the common interest.

And in the recent financial crisis, the agency problem proved to be the undoing of the financial system. When financial engineers turned mortgages into securities by issuing collateralized debt obligations, or CDOs, they thought they were reducing risk through geographical diversification. In reality, they were introducing a new risk by separating the interests of the agents who created and distributed the synthetic instruments from the interest of the owners of those securities. The agents were more interested in earning fees than in protecting the interests of the principals.

So the agency problem seemed ubiquitous.

Yet, in spite of its pervasive influence, it escaped attention until relatively recently. In my student days it was almost totally unrecognized. In the last twenty years it has received more attention, but mainly from economists who studied it in terms of contracts and incentives. In reality, the agency problem is more of an ethical problem and analyzing it in terms of contracts and incentives actually aggravated the ethical problem. Establishing the principle that people's behavior is governed by contracts and incentives had the effect of eliminating or at least diminishing ethical considerations. That may sound perverse but only because reflexivity is not well understood.

Values are less closely governed by an objective reality than cognitive notions; therefore they are more easily shaped by the theories that people adopt and economic theory is a case in point. Markets are supposed to act as an invisible hand, bringing demand and supply into balance. What makes the invisible hand so efficient is that there is no need to exercise moral judgment; all values can be expressed in terms of money and money is fungible. Pecunia non olet—money doesn't smell—the Romans used to say. But taking it for granted that all human behavior is guided by self interest leaves no room for the exercise of moral judgment-and society cannot exist without some ethical precepts.

The behavior of market participants is guided by market values, and market values are quite different in character from the moral values that are supposed to guide the behavior of people as members of society. This opens up a whole range of questions which I have not been able to resolve concerning the conflict between market values and social values. The agency problem has provided me with some new insights. I was also inspired by a short monograph by Bruce R. Scott on "The Concept of Capitalism." As a result, I may have something new to say. Indeed, I myself am shocked by some of the conclusions I have reached.

Scott argues that capitalism has been misinterpreted by conflating it with the market mechanism. This is a distortion that Scott attributes mainly to Milton Friedman; I am less specific and attribute it to market fundamentalism. Scott argues further that behind the invisible hand of the market lurks the visible hand of human agency, namely the political process, which sets and administers the rules. That is where the agency problem comes into play; so does the conflict between market values and social values.

The United States is a democratic, open society, based on the freedom of the individual, protected by the rule of law as defined by the Constitution. At the same time, the American economy is based on the market mechanism which allows individuals to engage in free exchange without undue interference from arbitrary actions by governmental authority. The political and economic arrangements seem to fit together seamlessly. One could easily speak of an open society and a market economy in the same breath, and people, including me, often do. But appearances are deceptive. There is a deep-seated conflict between capitalism and open society, market values and social values. The conflict has been successfully covered up by the market fundamentalist ideology which gained the upper hand in the 1980's during Ronald Reagan's presidency.

The distinguishing feature of the market mechanism is that it is amoral: one person's dollar is worth exactly the same as another person's, irrespective of how she came to possess it. That is what makes markets so efficient: participants need not worry about moral considerations. In an efficient market, individual decisions affect market prices only marginally: if one person abstained from participating as either buyer or seller, someone else would take her place with only a marginal difference in the price. Therefore individual market participants bear little responsibility for the outcome.

But markets are suitable only for individual choices, not for social decisions. They allow individual participants to engage in free exchange; but they are not designed to exercise social choices such as deciding the rules that should govern society, including how the market mechanism should function. That is the purview of politics. Extending the idea of a free-standing market, self-governing and self-correcting, to the political sphere is highly deceptive because it removes ethical considerations from politics which cannot properly function without them.

In the United States politics takes the form of representative democracy. People elect representatives who operate the levers of power. They are agents who are supposed to represent the interests of the people. In reality, they tend to put their own interests ahead of the interests of the people. Getting elected is expensive and representatives are beholden to their supporters. Those who don't play the game don't get elected. That is how money pollutes politics and special interests trump the public interest.

The agency problem in the American political system is not new. It is inherent in a representative democracy. The right to petition elected representatives was written into the Constitution. Yet the agency problem seems to be much more severe today than it was even as recently as my arrival in the United States in 1956. Why?

There are some objective historical developments which may be held partly responsible, notably the development of sophisticated methods of manipulating public opinion, and the growth of special interests, but the main culprit is a decline in public morality fostered by the rise of market fundamentalism.

I would like to think that at the time of the founding of the republic, citizens were genuinely guided by a sense of civic virtue. Fortunately, the founding fathers did not put much faith in that and built the Constitution on the division of powers: they created checks and balances between competing interests. That is why the Constitution holds up so well in spite of the decline in morality. Even when I first arrived, in 1956, people professed to be guided by intrinsic values like honesty and integrity. It may have been hypocritical with all kinds of vices clandestinely practiced but still, it was very different from today's public life where the blatant pursuit of self-interest is openly admitted and people are admired for being successful, irrespective of how they achieved it.

I do not want to be misunderstood. Painting too rosy a picture of the past is characteristic of people of a certain age and I do not want to fall into such an obvious trap. I do not claim that politicians were more honest or society was more just in 1956. America has made great progress since then in transparency, accountability, and social equality. But there has been a remarkable transformation in what behavior is socially acceptable and even admirable due to the rise of market fundamentalism. I describe it as a decline in public morality in a very special sense by contrasting it with the amorality of market values.

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I define market fundamentalism as the undue extension of market values to other spheres of social life, notably politics. Economic theory claims that in conditions of general equilibrium, the invisible hand assures the optimum allocation of resources. This means that people pursuing their self-interest are indirectly also serving the public interest. It gives self-interest and the profit motive a moral imprimatur which allows them to replace virtues like honesty, integrity, and concern for others.

The argument is invalid on several counts. First, financial markets do not tend toward equilibrium. General equilibrium theory reached its conclusions by taking the conditions of supply and demand as independently given. The invisible hand of the market then brings supply and demand into equilibrium. This approach ignores the reflexive feedback loops between market prices and the underlying conditions of supply and demand. It also ignores the visible hand of the political process which lies hidden behind the market mechanism.

Second, general equilibrium theory takes the initial allocation of resources as given. This rules out any consideration of social justice. Most importantly, the theory assumes that people know what their self-interest is and how best to pursue it. In reality, there is a significant gap between what people think and what the facts are. Nevertheless, market fundamentalism has emerged triumphant. How could that happen?

One reason is that the main policy implication of market fundamentalism, that government interference in the economy should be kept to a minimum, is not as unsound as the arguments employed to justify it. The market mechanism may be flawed but the political process is even more so. Participants in the political process are even more fallible than market participants because politics revolve around social values whereas markets take the participants' values as given. As we have seen, social values are highly susceptible to manipulation. Moreover, politics are poisoned by the agency problem. To guard against the agency problem, all kinds of safeguards have to be introduced and this makes the behavior of governmental authorities in the economic sphere much more rigid and bureaucratic than the behavior of private participants. On all these grounds, it makes sense to argue that governmental interference in the economy should be kept to a minimum. So market fundamentalism has merely substituted an invalid argument for what could have been a much stronger one. It could have argued that all human constructs are imperfect and social choices involve choosing the lesser evil, and on those grounds government intervention in the economy should be kept to a minimum. That would have been a reasonable position. Instead, it claimed that the failures of government intervention proved that free markets are perfect. That is simply bad logic.

I want to make myself quite clear: I condemn market fundamentalism as a false and dangerous doctrine but I am in favor of keeping government intervention and regulations to a minimum for other better reasons.

By far the most powerful force working in favor of market fundamentalism is that it serves the self-interests of the owners and managers of capital. The distribution of wealth is taken as given and the pursuit of self-interest is found to serve the common interest. What more could those who are in control of capital ask for? They constitute a wealthy and powerful group, well-positioned to promote market fundamentalism not only by cognitive arguments but also by the active manipulation of public opinion. Market fundamentalism endows the market mechanism, which is amoral by nature, with a moral character and turns the pursuit of self-interest into a civic virtue similar to the pursuit of truth. It has prevailed by the force of manipulation, not by the force of reason. It is supported by a powerful and well financed propaganda machine which distorts the public's understanding of its own self-interests. For example, how else could the campaign to repeal the estate tax, which applies only to an elite 1 percent of the population, have been so successful?

There are, of course, competing forces in that arena using similar methods of manipulation but they tend to be less well financed because they cannot draw on the self interest of the wealthiest and most powerful segment of the population. That is how market fundamentalism has emerged triumphant in the last 25 years and even the financial crisis was not sufficient to impair its influence. This was demonstrated by President Obama's decision to avoid recapitalizing the banks in a way that would have given the government majority control.

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Market fundamentalism should not be conflated with the efficient market hypothesis. You can be an economist working with that hypothesis without being a market fundamentalist. Indeed, many economists are bleeding heart liberals. But the efficient market hypothesis has a stranglehold on the teaching of economics in American universities and that phenomenon can be attributed to the financial support given by capitalists and foundations committed to market fundamentalism. They are also responsible for the encroachment of market values into other disciplines like law and political science.

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Capitalism is not directly opposed to open society the way Soviet communism was. Nevertheless, it poses some serious threats. I have already discussed one of them; financial markets are not equilibrium-bound but bubble-prone. The dismantling of the regulatory mechanism has given rise to a super- bubble whose bursting will negatively influence the American economy for several years to come. This discussion has revealed another threat to open society: the agency problem and the influence of money in politics, which contaminate the political process.

In an open society, the political process is supposed to serve the common interest; in contemporary America, the political process has been captured by special interests. Our elected representatives are beholden to those who finance their election, not to the electorate at large. What is happening to President Obama's healthcare and energy bills provides a vivid illustration. The electorate has been brainwashed to such an extent that a responsible discussion of the public good has become well-nigh impossible. A national health service and a carbon tax are nonstarters. Our choices are confined to solutions that can be gamed by special interests.

Lobbying is at the core of the agency problem. How can it be brought under control?

This is an ethical issue and not a matter of modifying economic incentives. Lobbying is lucrative and it is liable to remain so even if the rules are tightened. In the absence of moral values, regulations can always be circumvented; what is worse, the regulations themselves will be designed to serve special interests, not the common interest. That is the danger facing the United States today when a wounded financial sector is seeking to regain its former pre-eminence.

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There is a way to deal with the ethical issue. We need to draw a clear distinction between the economic and political spheres. Market participation and rule making are two different functions. Markets allow participants to engage in free exchange. Here it is quite legitimate for participants to be guided by the profit motive. By contrast, the making and enforcement of rules ought to be guided by consideration of the public good. Here the profit motive is misplaced. It is when people try to bend the rules to their own advantage that the political process becomes corrupted and representative democracy fails to produce the results that would make open society a desirable form of social organization. It should be emphasized that this argument directly contradicts the currently fashionable market fundamentalist attitude which speaks of a political marketplace.

How could the political process be improved in an open society? I propose a rather simple rule; people should separate their role as market participants from their role as political participants. As market participants we ought to pursue our self interest; as participants in the political process we ought to be guided by the public interest. The justification for this rule is also rather simple. In conditions close to perfect competition no single competitor can affect the outcome; therefore individual market decisions have no effect on social conditions, whether or not one cares about the common good. But political decisions do affect social conditions; therefore it makes all the difference whether or not they serve the public interest.

The trouble is that the public good cannot be determined by reference to a generally accepted objective standard. It is contingent on the views of the electorate but in the absence of an objective standard, those views are easily manipulated. And manipulation is self-reinforcing; the more outrageous the political claims and counter claims, the harder it is to tell what is right and what is wrong. That is what has made the political process so ineffective.

By contrast, the market mechanism functions much better. People may not know what is good for them but profits do provide an objective criterion by which market participants' performance can be measured. No wonder that the profit motive has gained such prominence among the values that guide people's behavior. Not only do profits provide the means for the pursuit of whatever ends people may have, but they also serve as an end in itself because as a reliable measure of success they attract other people's admiration and generate self-esteem. Indeed, many successful business people feel much more secure in making money than in using their wealth.

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The spread of market values has brought immense economic benefits. Looking back in history, Christianity used to treat the pursuit of profit as sinful. This hampered economic development. The Reformation then facilitated the development of markets and opened the way to material progress and the accumulation of wealth. Society underwent a great transformation. Traditional relationships were replaced by contractual ones. Contractual relationships came to penetrate into more and more spheres of social life and eventually relationships started to be replaced by transactions. The pace of change continued to accelerate; it sped up tremendously during my lifetime.

The difference between my childhood in Hungary and my adult life in America is quite dramatic, so were the changes that occurred in America between my arrival in 1956 and the present day. When I first came to America, I was struck by how much further market values had penetrated into society than in my native Hungary or even England, where traditional values and class distinctions still prevailed. Since then, both England and America underwent a further transformation. The professions like medicine and law became businesses. In my view, this has had a destabilizing effect on society just as market fundamentalism has had a destabilizing effect on financial markets.

Exactly what level of stability is socially desirable is of course a matter of opinion. What is the proper role of the profit motive in the professions such as law and medicine and the media is similarly open to debate. But there can be no question that the profit motive has had a nefarious influence in the political sphere because it has aggravated the agency problem.

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How can the agency problem be minimized? It is too much to expect those who have a vital special interest at stake not to lobby Congress. The tobacco industry is bound to oppose legislation against cigarettes and the insurance industry will be against a single payer healthcare system. But those who do not have a vital interest at stake ought to give precedence to the public interests over their narrow self-interests. They need not be bothered by the so-called free rider problem, namely that others who act more selfishly would also benefit from their unselfish behavior because the objective of the exercise is to benefit the public.

To sum up, yesterday I argued that the cognitive function ought to be given precedence over the manipulative function. Today, I argued that while the profit motive is perfectly justified within the existing rules, when it comes to making the rules the public interest out to be given precedence over personal interests. I firmly believe that even if a small portion of the electorate met these two requirements, representative democracy would functions better.

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I should like to end on a personal note. I have practiced what I preach. As a hedge fund manager I have played by the rules and tried to maximize my profits. As a citizen I try to improve the rules, even if the reforms go against my personal interests. For example, I support the regulation of hedge funds along with other financial institutions. I firmly believe that if more people followed this precept our political system would function much better. I also believe that foundations like mine can play an important role exactly because so few people follow that precept.

In my foundation, the Open Society Institute, we have made it our business to protect the public interest against the encroachments of private interests. We are also supporting civil society in holding governments accountable. I would describe these endeavors as political philanthropy and I believe that it can make a greater contribution to making the world a better place than more conventional philanthropy because fewer people are engaged in it.

I am in a privileged position. I am more independent than most people because I don't depend on clients or customers and I feel under a moral obligation to put my privileged position to good use. I am of course heavily outgunned by special interests but at least I have the satisfaction that my money has greater scarcity value.

The trouble is that special interests also seek to disguise themselves as protectors of the public interest and it takes a discerning eye to discriminate between the genuine and the phony, especially as both sides are forced to resort to similar methods of persuasion. In the absence of objective criteria, one can only reach a judgment by a process of trial and error. People of good intentions engaged on one side of the debate often find it difficult to believe that there are people on the other side with equally good intentions. The best way to find out is by taking their claims at face value and engaging them on the substance of their argument. This has the beneficial effect of giving the cognitive function precedence in the political debate. Only if they fail to respond in kind should they be dismissed and subsequently ignored. There are people like that in every country; unfortunately in the United States they are not ignored. They have become very influential. Whether the electorate also refuses to be influenced by people who try to manipulate them with total disregard for the truth is the test that every open society has to pass to remain open. Given the success of Orwellian propaganda, America is not doing well in this regard.

The political process which has served America well for two centuries seems to have deteriorated. We used to have two parties competing for the middle, but the middle ground has shrunk and politics have become increasingly polarized. President Obama has done his level best to reverse the trend, he has tried to be the great unifier, but to no avail.

In the end, how a democracy functions depends on the people who live in it. I believe that if more people separated their role as political participants from their role as market participants, American democracy would function better. It is up to each individual. That is what I have done. Even a small minority could be helpful in rebuilding the vanishing middle ground.