ing at many of the more outrageous provisions in licensing agreements. The New York Attorney General filed suit against Network Associates in February, describing their anti-review provision as a "censorship clause" and asking the court to prevent NA from using it.

Furthermore, the computer industry's effort to get states to enact the model Uniform Computer Information Transactions Act legislation is faltering. The legislation would allow companies to more easily enforce software licensing agreements and limit their liability by removing software as a consumer good subject to the normal consumer laws. But despite the best efforts of software companies and online services, it has been made law in only Maryland and Virginia because of opposition from a variety of organizations, including consumer groups, state attorneys general, computer professional associations, and businesses that buy software.

An important force for change will likely be the insurance market. In July, a federal court ruled that AOL's insurer did not have to cover the costs of a settlement the company struck to settle software problems that prevented thousands of users from getting online. In addition, firms themselves are starting to purchase additional insurance to protect themselves against bugs and cyberattacks, and insurance companies are responding by imposing higher rates on companies using buggy products. One firm already charges 15 percent higher e-commerce premiums to companies using Microsoft's IIS Web hosting platform than those using its competitor, Apache. If this practice spreads, software manufacturers will have to improve their products or risk losing business.

Holding manufacturers liable for software and system flaws will not solve all the security problems. Users will still have to screen for viruses and install firewall software, just as drivers must obey traffic safety laws. But it is time to stop expecting users to pay the price for manufacturers' mistakes. ❋

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By Alice M. Rivlin ILLUSTRATIONS BY GRADY Mc

Challenges of

FERRIN

modern capitalism

The 1990s treated the world to a vivid demonstration of how well free-market capitalism can work when all the conditions and policies are right. But making good public policy is genuinely hard. The job of reformers is to find ways to do it better.

REMARKS TO THE BOSTON ECONOMIC CLUB
APRIL 17, 2002

I want to raise a big subject today—our modern, free-market capitalist system and three major challenges it faces. I use the word "challenges," but "dilemmas" might be better. A challenge suggests an obstacle that can be overcome by making a greater effort; but dilemma implies that there is no obvious right answer. A dilemma can be worked through, but only with continuous balancing of competing objectives, and dilemma better describes what I want to discuss.

The first dilemma is illustrated by the widening disparity in incomes and wealth in the United States, as well as in the world: how to make free-market capitalism work better for everyone—not just the educated, the skilled, and the lucky.

The second is illustrated vividly by the Enron/Arthur Andersen fiasco: how to ensure a culture of integrity, one in which people who run companies, especially big ones, strive to merit the trust of investors and employees.

The third is exemplified by current battles over the federal budget and similar local dramas playing out all over the country: how to ensure that our enthusiasm for harnessing private motives to produce goods and services efficiently does not blind us to the need for public goods and to the benefits of communities working together toward shared goals. ››

LEARNING FROM THE 1990s

The 1990s were an extraordinary period in U.S. economic history. For a whole decade, starting early in 1991, we experienced sustained growth, low unemployment, low inflation, and rising incomes. Productivity growth, which determines real incomes, surged unexpectedly in the second half of the nineties. Economists are not sure of the reasons for the pickup, although technology was clearly a big part of the story. Monetary and fiscal policies combined to keep interest rates low and made investment attractive. Both policy and economic forces compelled U.S. business to be more competitive or be wiped out. Freer trade, deregulation, and global competition all contributed to greater U.S. competitiveness, as did more effective management techniques and more flexible compensation and production.

We learned at least two lessons from the economic experience of the last decade. First, we learned—or rather relearned—that low unemployment rates are a powerful positive force. With tight labor markets, wages moved up at the bottom as well as the top. Scarcity of labor provides effective incentives—both for individuals and for companies—to invest in training and education and to use skills and workers effectively. Second, we learned that we can have low inflation *and* low unemployment at the same time if productivity is growing fast enough.

The boom of the 1990s treated the world to a vivid demonstration of how well free-market capitalism can work when all the conditions and policies are right, especially when rapid technological change is propelling growth in productivity and labor is scarce. That is when flexibility and competitiveness pay off, capital moves quickly into new ventures—although not all of them succeed—and it is relatively easy for people to move from declining industries into new ones.

The timing of this demonstration was fortuitous, because it followed closely the break-up of the Soviet bloc and contrasted with an equally vivid demonstration that centrally planned economies don't work. The abilities or motivations of central planners are not the issue. Even highly skilled and public-spirited people cannot make a centrally planned economy operate so as to produce a high standard of living. The problem is just too complex. It is much more efficient to let private incentives and the profit motive do the job of deciding what to produce and how to produce it. Free-market economies create far more opportunity for individuals to use their talents. They also provide less opportunity for corruption, since power is more diffused and can be competed away.

That lesson has been widely absorbed, although the transitions are horrendously difficult, as Russia, Eastern Europe, and China have all found. But despite the difficulties, the tide does not seem likely to turn back in the direction of central planning and state ownership. Even the mixed economies of Europe and elsewhere have moved aggressively to privatize their state-owned industries and to introduce more competition and private incentives into public services such as health care.

THE DIFFICULTIES OF GETTING POLICY RIGHT

Just about everybody has concluded that a high-performance economy has to be one in which the dominant motivation behind economic activity is a pursuit of personal gain. What is not widely recognized is that the easy part of a free-market economy is the market part. The hard part is creating the public policy environment within which the market can operate effectively.

We don't stop very often to think about how demanding a task we have given our policy makers. Indeed, Americans are in almost continuous high dudgeon over the failures of our policy makers. We think we are justifiably disappointed that they spend so much time arguing and never get things right. We

PHOTOGRAPH BY CHRISTOPHER HARTLOVE

Millions of Americans still work for minimum wages at draining jobs with little security and not much future

shake our heads and mutter that if only we had better people or stronger leadership in Washington or Boston everything would be okay. Or we blame democracy—at best a messy way to make decisions—without realizing that most of the problem is not the democratic process. The fact is that making public policy for a free-market economy is genuinely hard.

What makes it so hard? First, if markets are to work, there have to be rules of the game about property rights, bankruptcy, contracts, and not injuring others in specified ways. And the rules have to be enforced. Countries in transition from centrally planned economies to free-market capitalism have found out how hard it is to make capitalism work if those rules—and the institutions that enforce them—don't exist or don't have a long and rich history.

Second, there have to be social, environmental, and other public policies in place to handle the fact that people and companies operating in their own interests tend to load costs onto others when they can and leave behind those unable to fend

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> Fixing the rules visibly and swiftly will reassure investors that company financial statements tell the truth

for themselves. And third, there are genuine public goods—armies and navies, police, roads, parks, and public health services—that private investors operating on their own will not provide.

Dealing with these questions is the intellectually and morally challenging aspect of a free-market system. It requires constantly adjusting incentives and regulations, just enough to accomplish a public purpose and move activities modestly in one direction or another, without impeding the main action of the private-sector players and the productivity of their operations. The process is complex and contentious, and the policy makers can never get it right. They have to keep tinkering as conditions change. That's why our tax code is so complicated. That's why it is so difficult to "fix" the welfare system or Medicare.

For many decades, those dissatisfied with economic outcomes held out the hope that some other system would work better. Now that hope is lost. Reformers have to turn to the hard task of improving the rules and making free-market capitalism work better. This process is hard work and does not lend itself to slogans and demonstrations. The young demonstrators who march outside international meetings (the World Bank, International Monetary Fund, World Trade Organization, G-7, etc.) and shout "Down with capitalism!" are responding to real problems, but not contributing to real solutions. They are fundamentally anachronisms—relics of a day when it was plausible to shout "down with capitalism," because socialism, communism, or Maoism seemed to be viable alternative systems.

REDUCING INCOME INEQUALITY

Today, free-market capitalism has won the contest among systems in a fair fight, and the job of reformers is to make it work better. But these dilemmas of modern capitalism that I want to talk about have no easy or obvious answers, because they involve balancing sometimes conflicting values that are widely and simultaneously held.

First, how do we make capitalism work better for people in the bottom quarter or third of the distribution of skill, education, income, and luck? In this regard, the world's biggest problem is in developing countries, but I'm not going to talk about that today. We have a big enough dilemma here in the United States.

In the 1970s and 1980s, the gap between the top and the bottom of the income distribution widened both because incomes at the top were moving up and because people in the lower third of the income distribution were seeing their real incomes falling. The 1990s were better because—at least by the second half of the decade—even unskilled workers were scarce, so wages began moving up at the bottom. Low unemployment rates meant that more people had jobs at better pay. Meanwhile, premiums for skill, education, and risk taking were rising very fast. People with college and graduate degrees were doing *really* well.

But even in the prosperous 1990s, the richest, most productive country in the world had a lot of people living on the edge of desperation. Millions of people still work at the minimum wage or not much above, at hard, draining jobs with little security, no health insurance, and not much future. Many are single moms whose kids are getting a tough start in life; some are older workers without the skills to make it in the modern economy. A lot of working people see this economy generating enormous rewards—high salaries, expensive effective medical care, fancy cars, and vacations—for other people, while they are left behind. They don't feel part of the general prosperity or have much hope for the future.

This situation isn't inevitable, but it isn't easy to fix. No magic solutions exist, and no single set of actions—whether by federal, state, or local officials, by corporations, by small businesses, or by community groups—can make it happen. But the combined effect of many actions, public and private, would make a difference. They must balance the benefits of raising rewards for lower-skilled workers against the risk of reducing their incentives to work and the incentives of employers to hire them—a challenging task.

There are plenty of useful tools available. At the federal level, we can raise the minimum wage (but not too far), increase the earned income tax credit or food stamps, or provide vouchers to make decent housing more affordable. Welfare reform has "worked," in the sense that it has moved a lot of low-skilled mothers into the labor force. But their jobs are precarious and mostly do not pay enough to put them on a solid track to self-sufficiency. Actions that would help include improving schools, mentoring kids, revitalizing neighborhoods, and providing more money for student aid for college and technical education. It's a long list. But the most obvious way to make life better for low-income workers is to improve their access to health care. It is unconscionable that more than 40 million Americans don't have health insurance, most of them in working families. But there is no easy way—as the Clinton administration found out—to balance all the incentives. These include incentives to providers to deliver good quality care and deliver it efficiently; incentives to individuals to seek care when

they need it, including preventive care, but not to overuse it; and incentives to employers to cover their workers, but not lock them into their jobs.

One big thing *not* to do right now is reduce tax rates on the top quarter of the income distribution. The benefits of the enacted tax cuts scheduled to take effect later in the decade go entirely to the top quarter, and disproportionately to the top 1 percent. These are not the people who need tax reductions, and there is no convincing economic argument for such cuts. In the 1970s and 1980s, when productivity was growing slowly, advocates of cutting tax rates in the top income brackets used to talk about the need to increase incentives to invest. But the economy of the 1990s—with its high investment and rapid productivity growth—undermined that case. Advocates of tax cuts for those at the top are left with arguments such as "It's our money," or "Those who oppose reducing taxes are fomenting class-warfare."

IMPROVING CORPORATE CULTURE

The second dilemma is dramatically illustrated by the spotlight on Enron and Arthur Andersen. The story will play out in the courts, but there is not much doubt about the basic facts: Enron's public accounts didn't give a true picture of its situation, *and* insiders profited hugely while misleading stockholders and employees.

In many ways, the Enron story is an example of the swift justice and the self-corrective mechanisms of a free-market economy. Getting caught misleading investors is punishable by death, and there is no appeal from the court of investor wrath. The company failed. It won't be resurrected from bankruptcy, and its auditors went down with the ship. Bankruptcies are an effective punishment that planned economies don't have.

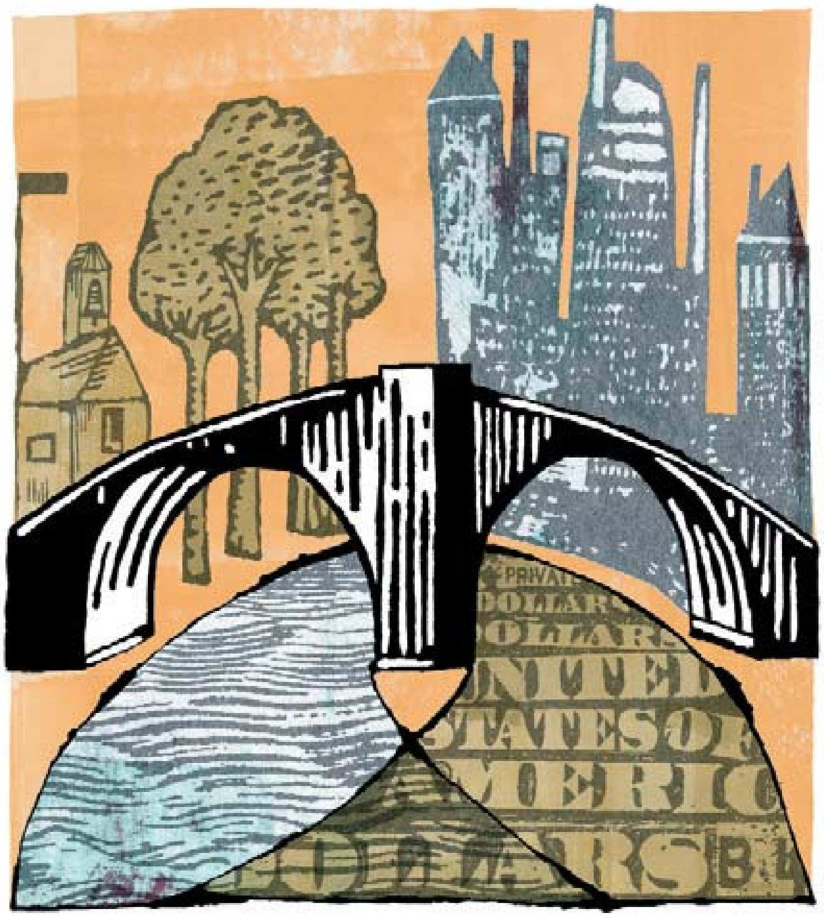
But Enron also demonstrated that we don't have the rules of the game right yet. The essence of free-market discipline is that publicly traded companies disclose their earnings, assets, and liabilities for all to see. On that basis, investors decide whether to invest. The accounting rules haven't caught up with the rapidly increasing complexity of business transactions, as the current discussion of special-purpose entities amply demonstrates. Enron and other companies have been able to overstate earnings, hide debt off the balance sheet, and create a rosier picture than reality.

Even more dismaying have been insider deals that enriched executives at the expense of shareholders, many of whom were employees—and the spectacle of executives touting the soundness of the company's stock while secretly dumping their own.

Irresponsible behavior and corporate excesses abuse trust in egregious ways—not just trust in one company, but trust in the whole system. People working hard for low wages may be having a tough time, but many still believe that they and their children have a chance to do better in the future and to get ahead in a system that rewards work, skill, and ingenuity. But if they come to believe that the system is corrupt, that the bosses lie and cheat and make out like bandits at the expense of hard-working folks, something very fundamental is lost. That's why Enron and Andersen matter so much. It is why the rules need to be fixed quickly and visibly to reassure investors that what they see on the earnings statement and balance sheet is what is really happening.

But, rewriting the rules is harder than it sounds. Modern transactions are extremely complex, and accounting for them involves complex rules that may have unforeseen and counterproductive consequences. The simple idea of requiring that compensation in the form of stock options be counted as an expense sounds like a no-brainer until you start writing the rules for valuing the options and worrying about the differential effects on various kinds of companies.

And yet, even without rule changes, the Enron/Andersen debacle is already having positive effects. Companies and their auditors are examining their policies and bending over backwards to make sure they don't run the risk of becoming the next headline.



> There are things we need government to do—or at least to organize

PROVIDING BETTER PUBLIC SERVICES

The third dilemma of capitalism involves improving public services. Our economic system depends on harnessing private motives to produce the goods and services that the public wants as efficiently as possible. This works well for most of the things we need, but not for some of the most important—national defense, police and fire protection, roads and bridges, research and education. The danger is that we get so carried way with free-market rhetoric that we forget how important public services are and how important it is to attract able people into public service.

Americans have a long tradition—going back to the Boston Tea Party—of rejecting authority. In recent years, it has again become popular to rail against the government as though it belonged to some foreign power, instead of to us. We have been treated to the comic spectacle of politicians who have worked for the government for most of their careers campaigning against the government and its "bureaucrats" as though they were talking about a foreign enemy. Then something brings us up short.

In 1995, while I was budget director, Congress voted to close the federal government rather than compromise with President Clinton over budget priorities. The congressional leadership thought the closure would be popular and that it would show people they could get along with less government. To the legislators' surprise, citizens were outraged that they couldn't go to national parks, get passports renewed, have their Federal Housing Administration housing loans approved, or get their student aid applications processed. They found out that government did useful things that they took for granted. We found out again on September 11th—when police officers and firefighters, soldiers and airmen were suddenly transformed into the heroes we were all depending on to save our lives and our way of life.

A free-market system, because it is so productive and efficient, can actually afford *better* public services, better schools and universities, better health care, better parks and recreation facilities, and better transportation systems than a centrally planned one. Some of these services can and should be provided by private philanthropy and citizen volunteers—a great strength of our system.

But sometimes our commitment to private decisions and the profit motive gets in the way of recognizing that there are things we need government to do or at least to organize. I believe that we are foolishly and short-sightedly underfunding some of our most essential government services. We don't pay enough to attract the most qualified and ingenuous teachers to that demanding profession that affects young people's lives so directly. We aren't investing enough in the modern sewer and waste treatment that could give us cleaner, more beautiful rivers. We aren't spending enough to ensure that everyone in society has health insurance and good-quality health care when they need it. We are not adequately funding the Social Security and Medicare programs that will come under increasing stress as the population ages.

The problem is not that we can't afford to do these things. It's more that our free-market rhetoric gets in our way. One legacy of the old battles among competing systems is that those most committed to the free-market economy think they have to starve public services because better schools or roads or cleaner rivers might lead us down the road to socialism. But that's silly—no one wants socialism anymore. The right-wing worriers are as anachronistic as the left-wing demonstrators.

The challenge for those who believe in free markets is to keep this great system working and, at the same time, to figure out how to make work pay better for those who do the hardest jobs at the lowest wages; how to maintain integrity in our corporate culture; and how to use our productivity and wealth to ensure that we have top-quality public services as well as private ones. ✻