

Does the free market corrode moral character?

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John C. Bogle

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The answer depends completely on what kind of market we are talking about and what we mean by “moral character.” Today’s supposedly “free market” could be described more accurately as a “fettered” market. Our financial and corporate regimes fall well short of the classic assumptions of perfect structure, perfect competition, and perfect information.

In the first edition of *Economics: An Introductory Analysis*, a textbook that I read during my sophomore year at Princeton in 1948, the Nobel laureate Paul Samuelson aptly summed up the issue: “the problem with perfect competition is what George Bernard Shaw once said of Christianity: ‘the only trouble with it is that it’s never been tried.’”

Another Nobel laureate, Joseph E. Stiglitz, has been even tougher on the recent failures of the free market. A former World Bank chief economist, Stiglitz notes that the corporate scandals of the last several years “involved virtually all of our accounting firms, most of our major banks, many of our mutual funds, and a large proportion of our major corporations.” His conclusion: “Markets do not lead to efficient outcomes, let alone outcomes that comport with social justice.”

I would argue that the effect is less causal than corollary. The wellspring of the current financial crisis has less to do with the fundamental character of markets, or of people, than with relatively recent structural changes

in the character of our financial and capital institutions. A little more than a half-century ago, we lived in what could be described fairly as an ownership society, one in which corporate shares were largely owned by individual investors. In this society, the “invisible hand” described by Adam Smith in the 18th century remained an important factor. The system was dominated by individual investors, who, pursuing their own self-interest, not only advanced the interests of society but exhibited such positive character traits as prudence, initiative, and self-reliance.

But in recent decades we have become an *agency* society, one in which corporate managers hold control over our giant publicly-held business enterprises without holding significant ownership stakes. Call it managers’ capitalism. Similarly, the financial intermediaries that now hold voting control of corporate America are agents for the vast majority of individual investors. In the early 1950s, individuals held 92 percent of all U.S. stocks, and institutions held just 8 percent. Today, individuals hold only 25 percent directly while institutions — largely mutual funds and pension funds — hold 75 percent.

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But these new agents haven’t behaved as agents should. Too frequently, corporations, pension managers, and mutual-fund managers have put their own financial interests ahead of the interests of the principals whom they are duty-bound to represent, those 100 million families who are the owners of our mutual funds and the beneficiaries of our pension plans. This failure is hardly a surprise. As Adam Smith wisely put it, “managers of other people’s money (rarely) watch over it with the same anxious vigilance with which... they watch over their own.... [T]hey very easily give themselves a dispensation. Negligence and profusion must always prevail.”

What’s more, the free-market system has been debased because our new institutional agents not only seem to ignore the interests of their investor *principals*, they also seem to have forgotten their own investment *principles*. In the latter part of the 20th century, the predominant focus of institutional investment strategy turned from the wisdom of long-term investing to the folly of short-term speculation.

When long-term *owners* of stocks become short-term *renters* of stocks, and when the momentary price of the stock takes precedence over the

intrinsic value of the corporation itself, concern about corporate governance is the first casualty. The single most important job of the corporate director is to assure that management is creating value for shareholders; yet that goal is secondary for our new agent/investors.

As for moral character, it is an absolute. One either has it or one does not. So if moral character in our society today is eroding (as I believe it is), it can only follow that fewer of our number display solid character and more of our number do not. Has the change from a free to a "fettered" market contributed to this development? Certainly. The values of our financial and corporate leaders have deteriorated. Not all that many decades ago, the rule seemed to be, "there are some things that one simply doesn't do." Let's call that moral absolutism. Today, the common rule is "if everyone else is doing it, I can do it, too." There can be no other name for this view than moral relativism.

46 This change helps to explain some of the recent aberrations in the free market. We have seen attempts to administer the prices of the goods and services we sell; the insane rise in executive compensation (30 years ago the average corporate CEO earned 40 times the compensation of the average worker; today the number is more like 500 times); financial engineering in the audited statements of firms in order to present the illusion of sustainable earnings growth; scandalous amounts of money paid to lobbyists hired to shape the law in favor of the rich and powerful; and excess risk-taking and expensive financial innovation by our banking system.

Now that the financial crisis is upon us, however, the burden is largely falling not on the irresponsible few who created it but on the many who, against the counsel of traditional thrift and prudence, were lured into it—namely, the investors in overrated mortgage-backed bonds and borrowers whose homes are being foreclosed at record levels. "Fettered" capitalism has indeed corroded our moral character, by both privatizing the rewards of the market and (in the form of federal bailouts) socializing its risks. Both are betrayals of the free market and its genuine virtues. Our society has a huge stake in demanding higher moral values in a less fettered market system.