

A Capitalist's Dilemma, Whoever Wins on Tuesday

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Published: November 3, 2012

WHATEVER happens on Election Day, Americans will keep asking the same question: When will this economy get better?

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Victo Ngai

Clayton Christensen, author of “The Innovator’s Dilemma,” says the winner of the presidential election must face “the capitalist’s dilemma.”

In many ways, the answer won’t depend on who wins on Tuesday. Anyone who says otherwise is overstating the power of the American president. But if the president doesn’t have the power to fix things, who does?

It’s not the Federal Reserve. The Fed has been injecting more and more capital into the economy because — at least in theory — capital fuels capitalism. And yet cash hoards in the billions are sitting unused on the pristine balance sheets of Fortune 500 corporations. Billions in capital is also sitting inert and uninvested at [private equity](#) funds.

Capitalists seem almost uninterested in capitalism, even as entrepreneurs eager to start companies find that they can’t get financing. Businesses and investors sound like the Ancient Mariner, who complained of “Water, water everywhere — nor any drop to drink.”

It’s a paradox, and at its nexus is what I’ll call the Doctrine of New Finance, which is taught with increasingly religious zeal by economists, and at times even by business professors like me who have failed to challenge it. This doctrine embraces measures of profitability that guide capitalists away from investments that can create real economic growth.

Executives and investors might finance three types of innovations with their capital. I'll call the first type "empowering" innovations. These transform complicated and costly products available to a few into simpler, cheaper products available to the many.

The Ford Model T was an empowering innovation, as was the Sony transistor radio. So were the personal computers of I.B.M. and Compaq and online trading at Schwab. A more recent example is cloud computing. It transformed information technology that was previously accessible only to big companies into something that even small companies could afford.

Empowering innovations create jobs, because they require more and more people who can build, distribute, sell and service these products. Empowering investments also use capital — to expand capacity and to finance receivables and inventory.

The second type are "sustaining" innovations. These replace old products with new models. For example, the Toyota Prius hybrid is a marvelous product. But it's not as if every time Toyota sells a Prius, the same customer also buys a Camry. There is a zero-sum aspect to sustaining innovations: They replace yesterday's products with today's products and create few jobs. They keep our economy vibrant — and, in dollars, they account for the most innovation. But they have a neutral effect on economic activity and on capital.

The third type are "efficiency" innovations. These reduce the cost of making and distributing existing products and services. Examples are minimills in steel and Geico in online insurance underwriting. Taken together in an industry, such innovations almost always reduce the net number of jobs, because they streamline processes. But they also preserve many of the remaining jobs — because without them entire companies and industries would disappear in competition against companies abroad that have innovated more efficiently.

Efficiency innovations also emancipate capital. Without them, much of an economy's capital is held captive on balance sheets, with no way to redeploy it as fuel for new, empowering innovations. For example, Toyota's just-in-time production system is an efficiency innovation, letting manufacturers operate with much less capital invested in inventory.

INDUSTRIES typically transition through these three types of innovations. By illustration, the early mainframe computers were so expensive and complicated that only big companies could own and use them. But personal computers were simple and affordable, empowering many more people.

Companies like I.B.M. and Hewlett-Packard had to hire hundreds of thousands of people to make and sell PC's. These companies then designed and made better computers — sustaining innovations — that inspired us to keep buying newer and better products. Finally, companies like Dell made the industry much more efficient. This reduced net employment within the industry, but freed capital that had been used in the supply chain.

Ideally, the three innovations operate in a recurring circle. Empowering innovations are essential for growth because they create new consumption. As long as empowering innovations create more jobs than efficiency innovations eliminate, and as long as the capital that efficiency innovations liberate is invested back into empowering innovations, we keep recessions at bay. The dials on these three innovations are sensitive. But when they are set correctly, the economy is a magnificent machine.

For significant periods in the last 150 years, America's economy has operated this way. In the seven recoveries from recession between 1948 and 1981, according to [the McKinsey Global Institute](#), the economy returned to its prerecession employment peak in about six months, like clockwork — as if a spray of economic WD-40 had reset the balance on the three types of innovation, prompting a recovery.

In the last three recoveries, however, America's economic engine has emitted sounds we'd never heard before. The 1990 recovery took 15 months, not the typical six, to reach the prerecession peaks of economic performance. After the 2001 recession, it took 39 months to get out of the valley. And now our machine has been grinding for 60 months, trying to hit its prerecession levels — and it's not clear whether, when or how we're going to get there. The economic machine is out of balance and losing its horsepower. But why?

The answer is that efficiency innovations are liberating capital, and in the United States this capital is being reinvested into still more efficiency innovations. In contrast, America is generating many fewer empowering innovations than in the past. We need to reset the balance between empowering and efficiency innovations.

The Doctrine of New Finance helped create this situation. The Republican intellectual [George F. Gilder](#) taught us that we should husband resources that are scarce and costly, but can waste resources that are abundant and cheap. When the doctrine emerged in stages between the 1930s and the '50s, capital was relatively scarce in our economy. So we taught our students how to magnify every dollar put into a company, to get the most revenue and profit per dollar of capital deployed. To measure the efficiency of doing this, we redefined profit not as dollars, yen or renminbi, but as ratios like RONA (return on net assets), ROCE (return on capital employed) and I.R.R. (internal rate of return).

Before these new measures, executives and investors used crude concepts like “tons of cash” to describe profitability. The new measures are fractions and give executives more options: They can innovate to add to the numerator of the RONA ratio, but they can also drive down the denominator by driving assets off the balance sheet — through outsourcing. Both routes drive up RONA and ROCE.

Similarly, I.R.R. gives investors more options. It goes up when the time horizon is short. So instead of investing in empowering innovations that pay off in five to eight years, investors can find higher internal rates of return by investing exclusively in quick wins in sustaining and efficiency innovations.

In a way, this mirrors the microeconomic paradox explored in my book “[The Innovator's Dilemma](#),” which shows how successful companies can fail by making the “right” decisions in the wrong situations. America today is in a macroeconomic paradox that we might call the capitalist's dilemma. Executives, investors and analysts are doing what is right, from their perspective and according to what they've been taught. Those doctrines were appropriate to the circumstances when first articulated — when capital was scarce.

But we've never taught our apprentices that when capital is abundant and certain new skills are scarce, the same rules are the wrong rules. Continuing to measure the efficiency of capital prevents investment in empowering innovations that would create the new growth we need because it would drive down their RONA, ROCE and I.R.R.

It's as if our leaders in Washington, all highly credentialed, are standing on a beach holding their fire hoses full open, pouring more capital into an ocean of capital. We are trying to solve the wrong problem.

Our approach to higher education is exacerbating our problems. Efficiency innovations often add workers with yesterday's skills to the ranks of the unemployed. Empowering innovations, in turn, often change the nature of jobs — creating jobs that can't be filled.

Today, the educational skills necessary to start companies that focus on empowering innovations are scarce. Yet our leaders are wasting education by shoveling out billions in Pell Grants and subsidized loans to students who graduate with skills and majors that employers cannot use.

Is there a solution? It's complicated, but I offer three ideas to seed a productive discussion:

CHANGE THE METRICS We can use capital with abandon now, because it's abundant and cheap. But we can no longer waste education, subsidizing it in fields that offer few jobs. Optimizing return on capital will generate less growth than optimizing return on education.

CHANGE CAPITAL-GAINS TAX RATES Today, tax rates on personal income are progressive — they climb as we make more money. In contrast, there are only two tax rates on investment income. Income from investments that we hold for less than a year is taxed like personal income. But if we hold an investment for one day longer than 365, it is generally taxed at no more than 15 percent.

We should instead make capital gains regressive over time, based upon how long the capital is invested in a company. Taxes on short-term investments should continue to be taxed at personal income rates. But the rate should be reduced the longer the investment is held — so that, for example, tax rates on investments held for five years might be zero — and rates on investments held for eight years might be negative.

Federal tax receipts from capital gains comprise only a tiny percentage of all United States tax revenue. So the near-term impact on the budget will be minimal. But over the longer term, this policy change should have a positive impact on the federal deficit, from taxes paid by companies and their employees that make empowering innovations.

CHANGE THE POLITICS The major political parties are both wrong when it comes to taxing and distributing to the middle class the capital of the wealthiest 1 percent. It's true that some of the richest Americans have been making money with money — investing in efficiency innovations rather than investing to create jobs. They are doing what their professors taught them to do, but times have changed.

If the I.R.S. taxes their wealth away and distributes it to everyone else, it still won't help the economy. Without empowering products and services in our economy, most of this redistribution will be spent buying sustaining innovations — replacing consumption with consumption. We must give the wealthiest an incentive to invest for the long term. This can create growth.

Granted, mine is a simple model, and we face complicated problems. But I hope it helps us and our leaders understand that policies that were once right are now wrong, and that counterintuitive measures might actually work to turn our economy around.

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