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The Moral Hazards of Capitalism

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September 1, 2015

In the worlds of insurance and finance, moral hazard is said to exist when one party to a contract or transaction feels free to take undue risks because another party will bear the costs if things go badly. The classic example is an insurance policy that protects against all loss or damage to property, and thus inclines the policy holder to treat the property carelessly, knowing that the insurer will pay in full for replacement or repair. Avoiding moral hazard is the alleged purpose of deductibles and co-pays. If insurees are on the hook for part of the costs of their risky behavior, the logic goes, they will take fewer risks and not exploit the insurer.

The idea of moral hazard gained public currency when critics of the banking industry used it to explain the financial meltdown of 2008. Deregulation, they said, created a condition of moral hazard that led to irresponsible behavior by all the powerful actors in the system.

Commercial banks had incentive to make risky mortgage loans because repeal of the Glass-Steagall Act allowed them to offload that risk by selling the loans to investment banks. The investment banks turned these loans into marketable securities and paid ratings agencies handsome fees to understate their riskiness, making it easier to sell them to credulous investors. More cunning investors, aware that many of these mortgage-back securities were junk, took out insurance policies that would pay off when massive defaults occurred. A history of federal government bailouts gave these banks and insurance companies further reason to believe that they would not suffer even if the whole scheme collapsed.

The situation was indeed rife with moral hazard. All the institutional players bet on an outcome in which the potential costs of their imprudent risks would come home to roost in other people's pockets. Which is pretty much what happened, homebuyers and taxpayers being left holding the bill. That deregulation helped this to occur is clear. In another way, however, the financial meltdown is not a special case. Moral hazard is endemic to capitalism; regulation just keeps it from crashing the system more often.

What the concept of moral hazard points to is how political, legal, and economic arrangements conduce to irresponsible behavior that causes, or poses a grave threat of causing, serious harm to others. Capitalism is precisely such a set of arrangements. It is not that some people behave badly because they're evil. It's that the normal workings of capitalism invite, encourage, allow, and often compel people—those who control the means of production and of finance—to behave in ways that cause great harm to others or put others at great risk of harm.

The political, legal, and economic arrangements that matter most—the arrangements that define an economy as capitalist—are private ownership and control of the major means of production; private control of investment; and the accumulation of wealth by extracting surplus value from other people's labor. These arrangements give capitalists the ability and incentive to behave in morally irresponsible ways. This is not a fanciful Marxist hypothesis. It's what we see happening every day.

We see it when capitalists cheat workers out of wages. We see it when capitalists hold down production costs by refusing to pay for health and safety equipment or pollution controls, thus risking the lives and health of shopfloor workers and of everyone living downwind or downstream. We see it when capitalists knowingly sell defective or dangerous products (cigarettes are the paradigm example). We see it when capitalists extract fossil fuels in increasingly desperate ways that risk or create enormous environmental damage.

These are not deviant strategies in the capitalist scheme of things. The logic of capitalism requires, especially in competitive sectors of the economy, not only minimizing the costs of production but externalizing as many of those costs as possible and focusing on short-term returns. What this logic requires, in other words, is evasion of responsibility.

Capitalism's compulsions to immorality are also on display every time capitalists or their minions take the public stage and lie—about smoking causing cancer; about the health effects of pesticides, herbicides, and other industrial chemicals; about aerosols damaging the ozone layer; about climate change; and about their deep love for the earth. Acting in a morally responsible way requires seeking and accepting the truth about one's motives and the consequences of one's actions. But these are the truths that capitalists not only refuse to tell but vehemently reject whenever their profits and power are at stake.

Every form of exploitive economy, including capitalism, is built on a condition of moral hazard. This condition exists as soon as human beings are reduced to mere means to ends. People are "reduced" in this sense because what matters about them, in the eyes of their exploiters, is how much work they can do and how much of the value they create can be taken from them. What

this condition invites is the treating of people as manipulable, disposable things, treatment that would readily be recognized as dehumanizing, were it not so normalized.

Feudal lords, plantation owners, and capitalists can, as individuals, be more or less cruel to the people whose labor they exploit. But personal demeanor does not change the character of an institution. If the profit on which one's survival as a capitalist depends comes from extracting surplus value from the labor of others, then one must constantly strive to reduce the cost of that labor. Most of what workers are made to suffer under capitalism—economic hardship, lack of autonomy and control, indignities on the job, speed up, deskilling, periodic or chronic unemployment—stems from this basic operating principle.

But it is not just "workers" in the narrow sense who suffer or are put at risk because of the moral hazards of capitalism. We are all endangered by cost-externalizing strategies that befoul the environment or warm the planet. We are all put at risk by unsafe and defective products. We are all vulnerable to violent blowback from capitalist efforts to exploit natural resources, labor, and markets in other countries. We all risk being harmed when public infrastructure decays because government is starved by capitalists who, focusing myopically on their own enrichment, use their political power to cut or evade their taxes.

These vulnerabilities are of course not equally distributed; those at the bottom of the class ladder are at greater risk of harm. Awareness of this and a desire to avoid the worst that the system dishes out is what spurs competition to get ahead in capitalist society. This creates a secondary condition of moral hazard: incentive to treat fellow members of one's exploited class as competitors who must be defeated, or as resources to be used for one's advancement. For their part, capitalists have incentive to intensify this competition, if only by relentlessly touting the myth of upward mobility, because it divides and thereby weakens the working class. Here again capitalism reveals, in its bent for encouraging us to see others as means or obstacles to our own ends, its toxicity to morality.

An opposite view is often put forward based on the ideas of Adam Smith. In *The Wealth of Nations*, Smith argued that individuals working for their own gain are led by the invisible hand of the market to promote the social good. "It is not from the benevolence of the butcher, the brewer, or the baker," Smith wrote, "that we expect our dinner, but from their regard to their own interest." It matters not if these business folk intend only to get rich. The result, nonetheless, is a prosperous society in which people are bound together in harmony, as their desires for meat, beer, and bread are happily met.

Applied to transactions between small-scale artisan merchants and their customers, Smith's argument makes sense. But his philosophy is often mistaken to mean that pecuniary self-interest need not be restrained by other virtues. What Smith understood, as many of his modern acolytes do not, is that successful merchants must be able to see through the eyes of their customers and appreciate their desires not just for beef, beer, or bread, but for solidarity with respectful, trustworthy neighbors. It is this mutual sympathy, sustained by personal contact, that Smith argued acts as a check on immoral behavior more generally.

Proponents of the greed-is-good school of capitalist morality—most famously Milton Friedman—would have us believe that Smith's point about small-scale artisan merchants in 1776 suffices to legitimate the behavior of giant, impersonal corporations and investment banks in the 21st century. They would have us equate a baker's interest in making a living to a hedge fund manager's interest in making a killing. Of course the desire to do well economically can motivate constructive behavior. But under the conditions of moral hazard that obtain today, this desire, amplified by corporate power on a scale Smith never dreamed of, begets disaster.

Regulation is merely a palliative for the moral hazards of capitalism. Laws can forbid excessively risky behavior that jeopardizes other people's health and economic security. Laws can impose penalties for such behavior steep enough to make the risks not worth taking. But effective regulation depends on democracy; that is, it depends on the ability of ordinary citizens to use government to limit the potentially ruinous, selfish behavior of powerful economic actors. Which is why those same actors—today's corporate rich—oppose democracy in all but facade. Presuming that one sees democracy as a virtue, its inevitable decline as capital grows more concentrated and more powerful is another moral hazard of capitalism.

Taking a short view, there is no optimistic conclusion. A condition of moral hazard is part and parcel of capitalism, and so for now we are stuck with capitalism's inducements and compulsions to morally irresponsible behavior. What's more, trying to use regulation to solve the problem fates us to playing whack-a-mole, because capitalists, given the power that comes from ownership and control of society's major means of production, will always find ways to co-opt or evade whatever regulatory schemes and practices we might devise. On the other hand, struggling to limit the damage that otherwise unbridled capitalists can do is worth doing. Whacking moles can keep them from tearing things up as badly as they otherwise might.

Recognizing that degrees of moral hazard can be built into legal, political, and economic arrangements at least allows for optimism in the long run. The moral hazards built into capitalism can be built out of a non-exploitive, democratic economy. Such an economy would not require people to be socialist saints, always fully capable of the mutual sympathy that Adam Smith saw as essential to morality. It would require, more mundanely, laws, policies, and decision-making procedures that thwart the selfish, unlimited pursuit of wealth and power.

Even its defenders sometimes publicly admit that capitalism is a rigged game. The historical task, however, is not to try to unrig it, which can't be done. The task is to devise a more egalitarian game.