CHAPTER 1

A CONVERSATION

He who dies rich dies in disgrace.
—ANDREW CARNEGIE

The Giving Pledge

On August 3, 2010, the Wall Street Journal ran an article titled “U.S. Super Rich to Share Wealth.”1 The piece was about the Giving Pledge—an effort by Bill Gates and Warren Buffett to get the world’s richest individuals and families to give away half of their wealth during their lifetimes. The pledge’s initial outreach effort, which stemmed from Gates and Buffett’s conversations with wealthy individuals over the previous year, ended with forty American billionaires signing on. The article, published a day after the signing, was buried inside the paper and initially didn’t seem to create much excitement.

I expected the story to die, like the patchwork of other newspaper and magazine articles on philanthropy that I had been following over the previous decade—but the Giving Pledge story had legs! Within three months of the signing, it was one of the most talked-about topics in the country, and by the end of the year 7 percent of the traffic on Twitter
concerned it. The Giving Pledge has shaken public discourse on the topic of philanthropy and reopened a debate on the role that philanthropy plays in American capitalism.

Reading the letters of many of the signatories sheds light on what these philanthropists hoped to accomplish by giving their money away. George Lucas, the creator of the Star Wars franchise, wrote on the Giving Pledge website that he was “dedicating the majority of my wealth to improving education. It is the key to the survival of the human race.” Paul Allen of Microsoft wrote, “We will look for new opportunities to make a difference in the lives of future generations.” Pierre Omidyar, the founder of eBay, wrote, “People are inherently capable but frequently lack opportunity. . . . Our common challenge is . . . leaving a legacy of hope for those to come.”

Many of the letters written by the signatories of the Giving Pledge equate philanthropic giving with the creation of new opportunities for individuals. As I hope to show in this book, this cycle of giving—from philanthropy to new opportunity creation—has been an essential ingredient of American capitalism throughout the country’s history. Americans’ motivations for giving money, as well as the outputs of their generosity, are woven into the entrepreneurial spirit of America—a system that has both nurtured private innovation and sustained a pattern of private giving that exceeds three hundred billion dollars every year.

Despite the apparent generosity of signatories like George Lucas and Paul Allen, much of the public response to the Giving Pledge has been critical, often laced with cynicism about the motives of philanthropy and the extent to which philanthropy undercuts democratic processes. The Weekly Standard’s readers attacked the Giving Pledge as “grandstanding,” a “publicity stunt,” or “the work of socialists.”
The German magazine Der Spiegel reported in its international edition, “One billionaire ‘blasted the effort as a bad transfer of power from the state to billionaires.’” These attacks are misguided, however, because they fail to appreciate that philanthropy, far from being a new fad, is endemic to the entrepreneurial system from which it originated.

In addition to those who criticize philanthropy for its lack of accountability, others question what philanthropic giving can hope to accomplish. Carlos Slim, a Mexican telecommunications magnate who in 2010 overtook Bill Gates as the world’s richest man, scoffed at the Giving Pledge, saying, “Charity doesn’t solve anything.” Slim, himself a philanthropist, questioned whether contributions promised by signatories of the Giving Pledge would result in any measurable improvement for society. His provocative statement raises an interesting question, although perhaps not the one he intended. How do we define, or categorize, philanthropy vis-à-vis charity? As I will maintain throughout this book, it is important to think of philanthropy and charity as two separate things, even though they are often equated in public discourse and in reactions to events like the Giving Pledge.

Philanthropy necessitates a reciprocal relationship between the philanthropist and the beneficiary. When a philanthropist makes an investment, it requires the recipient to make some investment—such as in time and energy—to benefit from the largesse. For example, consider the case of a wealthy individual who donates money to start a university, as Leland Stanford did when founding the university that bears his dead son’s name. The recipients of Leland Stanford’s largesse—namely, students—do not benefit without making their own investment of the time and energy necessary to earn a degree from Stanford University. In
short, philanthropy is an investment that stimulates other investments. Charity, by contrast, requires no such reciprocal relationship. Soup kitchens are charitable, for example, because the recipient need only show up to receive the benefit.

So what? you may ask. Isn’t the distinction minor? Haven’t we always had both charity and philanthropy? The simple answer is yes. We have always had charity. Alms giving is as old as civilization. We have also had some form of philanthropy for a very long time. Patronage of the arts is also as old as civilization. What is new is America’s invented use of philanthropy as a vehicle not for its own ends but for the creation of opportunity for the broad middle class, to build a better society in the long run through hard work and sacrifice. The mix of charity and philanthropy matters. I do not want to argue that charity is bad, just that only charitable gifts that result in the creation of economic and social opportunity for individuals qualify as philanthropy. Philanthropy has a positive long-term externality for society, that is, it creates a better society in the long run.

Philanthropy touches aspects of American society from early childhood education programs to cutting-edge research on biotechnology. When one considers where the preponderance of money that is given away actually goes, the reciprocal relationship inherent in philanthropy begins to make more sense. Consider the biotech industry, in which the contributions made by philanthropists bear fruit only if they are met with trained scientists who can turn research dollars into life-saving medicines. The opportunity afforded to those in research is a reciprocal relationship, as is the ability of life-saving medicines to allow people to rejoin the workforce.
Philanthropy and America

The Giving Pledge is certainly one of the highest-profile discussions of philanthropy in recent history, and it singles out the commitment that some American business leaders have to extending opportunity beyond what is provided by the marketplace. But how much do the actions of those individuals reflect a broader, more ingrained feature of American generosity and giving? In this book, I argue that to understand philanthropy is to understand something about the American psyche and its fidelity to promoting enterprise and opportunity.

The Giving Pledge has reignited an American conversation about philanthropy, but this new conversation has roots in an ongoing dialogue that can be traced back to those who first left England. Consider, for example, a sermon that the Puritan leader John Winthrop delivered in 1630 on board the ship Arabella as it sailed to the New World. Winthrop’s shipmates in part were seeking refuge from religious intolerance. Appropriately, Winthrop’s sermon was titled “A Model of Christian Charity,” yet it laid forth a number of practical ideas about the necessity of industry and hard work, on the one hand, and the importance of frugality and humility, on the other.

These early colonists who came from England in the seventeenth and eighteenth centuries left a society that was on the cusp of experiencing an enormous burst of entrepreneurial activity, invention, and economic growth. But it was also a closed society, where the ability to participate was largely limited to those with land and title. This was most
apparent in the landed aristocracy with their vast wealth and disproportionate political influence. Yet even the great advances that would fuel the wool and textile industry in England benefited almost exclusively those with inherited lands who used this wealth to purchase inclusion in this period of entrepreneurial upheaval.

If the Puritans were around today, they might not be wholly pleased with the state of affairs in American business. The Puritans were wary of excessive profit making, reflecting their distaste, not for enterprise and industry, but rather for windfall profits divorced from self-reliance and hard work. Similarly, today the American psyche seems torn between its love affair with entrepreneurial success and its uneasiness with the trappings of inherited wealth. Thus, long before Andrew Carnegie proclaimed his so-called Gospel of Wealth, the Puritans and other early American colonists leaving Europe were laying an intellectual and moral foundation on which successive generations of enterprising Americans would build, helping to ensure that entrepreneurial profit seeking in the New World bore little resemblance to the entitled rent seeking of the Old World. Rent-seeking behavior is an attempt by an interested party (in this case the nobility) to alter the rewards in society in their own favor. This type of behavior does not increase wealth in society; it just changes its distribution.

Through these values, the American experiment has triumphed on a balance between altruistic behavior and self-interest. Self-interest and altruism, though very different motives for human activity, are in fact fundamental traits of human nature and both are crucial to maintaining the strength and vitality of any society. Philanthropy, as I argue in this book, is part of the implicit social contract that continuously nurtures and revitalizes a society.
Philanthropy is also an invisible, underappreciated force for progress in American-style capitalism—the secret ingredient that fails to get mentioned in economic accounts of capitalism. Including it gives us a fuller, more realistic picture of capitalism, and therefore a better handle on how to govern it. We have to rethink the economics of capitalism to incorporate the role of philanthropy—just as we did for entrepreneurship, following Joseph Schumpeter—if we are to create policies to promote its better aspects.8

American-Style Capitalism

In the aftermath of the Great Recession, the future of capitalism in America has moved to the forefront of debate in the United States. One strain of this new conversation has questioned whether the United States ought to move in the direction of Europe, toward a more robust government involvement in the marketplace. In many ways, this knee-jerk reaction to a financial crisis that was fueled by greed and inadequate oversight, and followed by a sustained period of economic malaise, is typical. The standard paradigm observers of capitalism use to understand the American system focuses on conflict between big and small government—privatized health care versus government-run programs, unions versus business, and regulation versus individual freedom.9

These old debates—which harken back to the ideological conflicts over the New Deal and the Great Society, as well as to American disagreements over the merits of European-style social democracy—undercut our focus on the entrepreneurial ingredients of American capitalism. Innovation in America will not live or die based on whether
we build one more government agency, or how we decide the particulars of labor disputes between large corporations and unions. What is of consequence, however, is how policymakers work to create the conditions necessary to incubate innovation and to nurture an environment in which these innovations can be efficiently commercialized.

Capitalism requires an interplay between individuals and government—between commerce and control. On this point, even the most extreme right-wing and left-wing political factions generally agree. Each society chooses its own rules to govern this interplay. What is American-style capitalism and is it distinct from other styles? American-style capitalism has pushed against the protected relationships between business and government that typify what I consider the worst examples of capitalism throughout the world. There are, of course, many differences between the United States and Europe. Europe has different labor markets and labor laws, and its social services (such as universal health care) are much stronger. But one crucial difference is the degree of entrepreneurial activity and innovation. Europe gave birth to just twelve new big companies between 1950 and 2007. America produced fifty-two in the same period. And Europe has only three firms founded between 1975 and 2007 on a list of the world’s five hundred largest publicly traded companies.

I have spent my academic career studying entrepreneurship, predominately in the United States and Europe, but also globally. I was first introduced to the notion of a uniquely American style of capitalism by studying data on entrepreneurship and innovation in the United States. Entrepreneurship is important everywhere, but the United States is a magnet for entrepreneurship like no other country. For example, in a recent ranking of seventy-nine countries on
variables including innovation, availability of venture capital, and the share of high-growth firms, the United States ranked first, far ahead of the European Union, Brazil, China, and India, and even ahead of small entrepreneurial countries such as Denmark, Singapore, and Israel.\(^\text{13}\)

The United States owes its entrepreneurial success in no small part to the opportunities it has afforded talented and hardworking immigrants. In the global competition for talent, America excels because it provides opportunity both through jobs, which are created by the marketplace, and through education and high-tech research, which are tied to philanthropy. In the United States, 20 percent of high-tech companies were started by immigrants or had immigrants on their founding teams.

At the heart of American-style capitalism—and the ability to attract and sustain entrepreneurial activity—is an acceptance of the cycle of creative destruction. To some, this is a double-edged sword. On the one hand, the forces of creative destruction enable superior innovations to displace old companies and products. This process can also be damaging, however, as the losers in this process are put out of work, and in some cases whole towns and regional economies can suffer. In some countries, government plays an active role in holding creative destruction at bay, whereas American politicians—and presumably voters—have supported a system that allows creative destruction to do its work. Americans seem to accept that although creative destruction creates uncertainty, it also nurtures dynamism and, perhaps most important, fuels the entrepreneurial spirit of American-style capitalism.

The tension in American-style capitalism, thus, is not between the winners and losers that are sorted out by creative destruction. Rather, the tension is between enabling
vast amounts of wealth creation for those who innovate and protecting opportunity for all Americans. If government and society put too much pressure on the system from either side, the balance of American-style capitalism could shift in fundamental ways.

Indeed, the growing income inequality in the United States could create lasting cleavages between rich and poor that would do irreparable harm. Among other things, it could damage our meritocracy—our system for allocating talent and good ideas to their most productive uses—which is necessary for a healthy entrepreneurial society. On the other hand, pushing too much on the institutions that enable vast accumulation of wealth could damage the incentive system. As I discuss in this book, philanthropy plays a vital role in easing this tension between encouraging wealth creation and strengthening the institutions of opportunity.

For wealth to invigorate the capitalist system it needs to be “kept in rotation” like the planets around the sun, and for this task American philanthropy is very well suited. Only through philanthropic investments—in particular through the organized, large-scale networks of what I call philanthropic entrepreneurialism—can the imbalance inherent in capitalist growth be corrected to create a self-sustaining process in which wealth creation is supported alongside social innovation and opportunity.

Philanthropists strengthen American-style capitalism in two ways. The first is that philanthropy, when targeted to universities, research, and other productive uses, lays the groundwork for new cycles of innovation and enterprise. As an economist, I understand that it is not always easy to measure the precise contribution that philanthropy has made to economic growth.
What we can be more certain of, however, is that the fruits of philanthropy are all around us, from our hospitals, schools, and universities to our museums, orchestras, and myriad other cultural institutions. Take the Rockefeller Foundation, for example, which is funded by the oil fortune made by John D. Rockefeller in the late nineteenth century. He founded some of America’s great research centers, such as the University of Chicago, the Rockefeller University (a medical research center), and the Brookings Institution (a nonpartisan policy research institute).

The second way philanthropy strengthens capitalism is that philanthropy—like creative destruction—provides a mechanism for dismantling the accumulated wealth tied to the past and reinvesting it to strengthen the entrepreneurial potential of the future. Through this recycling process, philanthropy is a partial answer to the question of what to do with wealth, which must be recycled to create social stability and opportunity for those who have to be helped to the starting line. When philanthropy is absent, wealth remains concentrated, rent seeking flourishes, and innovation suffers. Thus, philanthropy plays a much more central role in explaining American-style capitalism than economists recognize.

Philanthropy has the potential to mitigate inequality as it softens the hard edges of the free market. Recycling wealth reduces income inequality and contributes to a more just society. If you leave only money to the next generation, you leave them poor. They will squander it. This was true in the past, and it still pertains to systems that protect the nobility—the major difference between the American experiment and the class systems of old Europe. American philanthropists did not want to leave money to the next
generation, as was the tradition in Europe; they wanted to leave opportunity.

It is also important to note that the way in which philanthropy operates is itself entrepreneurial. Philanthropists are innovators of opportunity. They look to where society is most in need—to where they can have the biggest impact—and they create networks and institutions to achieve these goals. Philanthropy is thus consistent with the self-made American values of individual freedom.

One criticism of philanthropy is its lack of accountability, mainly because philanthropists—and the foundations they create to allocate their wealth—do not answer directly to the public. Philanthropy hardly operates in a vacuum, however. To the contrary, over the past century, philanthropy has been bound in a partnership between wealthy Americans and the progressive tides in medicine, education, and civil society. Philanthropists cannot create sustained initiatives by themselves, but must instead tap into the ready fabric of civil society, medicine, or science to find feasible projects. For example, in founding Rockefeller University—the first biomedical research institute in the United States—John D. Rockefeller did not create biomedical research out of nothing, but instead brought together existing research initiatives and scientific priorities that he believed would honor his legacy.

It would be misleading to argue that philanthropy is the only way in which society contributes to the public good. Government spending—fueled by the taxes it imposes on Americans, particularly the wealthy—also plays a role in reinvesting wealth in opportunity-creating ventures in areas such as medicine, scientific research, and education. In America, however, our model has never been purely about government spending, as it has been in much of Europe.
In part, this has been due to politicians’ and voters’ resistance to higher taxes and more expansive government involvement in industry and society. Taxes, in particular, have always seemed to Americans to be a necessary evil, largely at odds with the notions of individual freedom, and perhaps as a consequence they have often been infeasible as a policy instrument. Over the past few years, in the wake of the Great Recession, voters’ aversion to taxes and the inability of government to act in many policy areas underscore these issues. Philanthropy will never be the only way to invigorate wealth to create opportunity—but it is a necessary part of the American solution.

As the former U.S. president Bill Clinton has pointed out, “There has always been a gap between what the government can provide and what the private sector can produce, a gap charities have long helped to fill. But as our world and economies evolve, we have an opportunity and a responsibility to reconsider how to fill this gap—to rethink the relationship between economic and social challenges, so that benefits and opportunities are available to more people.” Philanthropy, whether or not Clinton was aware of it when he wrote that piece, has all along been an unstated principle that lies at the heart of American-style capitalism: that those who amass wealth must continually create opportunities by investing in society. In this book we will explore how most Americans, wealthy and otherwise, historically have exemplified this principle, and reveal the largely hidden role it has played in producing economic growth and prosperity.

The conversation we are having is fascinating precisely because philanthropists are not universally understood or admired. Just think of how some people disliked Bill Gates, just as they misunderstood the “robber barons” Andrew
Carnegie and John D. Rockefeller. Theirs is tainted money! But what if giving wealth away is the key that unlocks future opportunity and prosperity? Giving back does matter, and that is why we are having a conversation about it.

This book is a reflection on contemporary American-style capitalism, with its sharp focuses on the interplay between entrepreneurship and philanthropy, on the one hand, and wealth creation and opportunity, on the other. Using historical and institutional evidence, I trace this story through the centuries. Many philanthropists had humble beginnings, worked hard to make something of themselves, and later used their money to help improve the world. They gave back to the society that had made them successful, thereby helping others make their way successfully along the difficult path of life. The dynamic of American-style capitalism—a self-sustaining circle of opportunity, innovation, wealth creation, and philanthropy—has endured over the centuries.17

Our story begins with the founding of the Republic and the way in which Americans forged a new relationship between the dynamic forces of enterprise, wealth creation, and opportunity. The American experiment was built on unprecedented powers of discretion and self-reliance, yet over time these unwieldy forces have also been bound to the common good by the emergence of novel forms of institutional authority and internal restraint. American-style capitalism refers not to the embodiment of a superior political economy but to the idea that our institutions are fundamentally different from those of any other nation.

Institutions are important because they set the rules of the game and determine the incentive structure that influences our behavior. Institutions include any form of constraints that we devise to shape human behavior. They may
be formal or informal: tax policy, the rule of law, religion, and so on. Inheritance laws offer a case in point. In France, you must leave your wealth to your family. The United States fought against this convention and changed its laws to allow leaving money to other than family. Institutional constraints include both what individuals are prohibited from doing and under what conditions certain activities may be undertaken, who is punished and who is rewarded.18

Yet all is not well in America today. We have two populist political movements under way simultaneously: the Tea Party and Occupy Wall Street. In recent years, political rhetoric has increasingly placed blame on features of American capitalism. John Edwards’s description of “two Americas” provides just one example. America may be the first modern country to so successfully unite the dynamism of capitalism and entrepreneurship, but we may also be the first country to oversell the promise of this system. As Warren Buffett explained, “We can rise to any challenge but not if people feel we’re in a plutocracy—a state in which the wealth class rules. . . . We have to get serious about shared sacrifice.”19

It is by no means clear that the incentive structure for giving, or the attitudes toward humanity, stay in sharp relief in any society over the centuries. Robert Kennedy wrote more than forty years ago that, for “too much and for too long, we seemed to have surrendered personal excellence and community values in the mere accumulation of material things.”20 Are the right incentives in place to elicit good behavior? E. J. Dionne writes, “Thanks to Mitt Romney and such well-known socialist intellectuals as Rick Perry and Newt Gingrich, the United States is about to have the big debate on the nature of modern capitalism that should have started back in 2008.”21 What to do about wealth has put this debate front and center in the American consciousness.
On June 7, 2007, William Henry Gates III delivered the annual commencement address at Harvard. He noted that the focus on financial success among the best and the brightest has left the country devoid of moral role models. Greed has replaced decent conduct, and the American obsession with how to gain wealth has diverted attention from the real question of what to do with wealth. Gates reminded us that in successful societies, as in the sports arena, the goal posts need to be reset periodically to level the playing field. Resetting the goal posts helps the players get better, stronger, and faster, and the equipment becomes more innovative. So, in life as in sports, we now need to reset the goal posts.

Thus, we are left with some final questions: Is American-style capitalism working? Are there changes that need to be made to strengthen the relationships between entrepreneurship and philanthropy and between wealth and opportunity in America? One goal of this book is to consider the policies that can continue to best enable the marriage of philanthropic entrepreneurialism with American-style capitalism. Indeed, in this time of economic turmoil, polarized politics, and divergent incomes, it seems vital to ensure that the entrepreneurial spirit of American capitalism retains its ability to deliver opportunity.22

The Book

This book is written for my fellow economists and social scientists engaged in economic issues, their students who need to understand this, the policymakers they influence, and those in the general public who are interested in their children’s future. If our leaders through their advisors are
going to forge policies that lead to steady, sustained growth, greater economic equity, and enhanced prosperity, philanthropy is a key, if little-understood, factor. Our institutions that influence philanthropic behavior and the organizations philanthropists build need to be better understood. The rules that influence philanthropy have evolved and need to be better understood to help maximize the positive effects of this distinctive force within American-style capitalism.

American prosperity is often defined in terms of easily expressed statistics, such as GDP and GNP. Such figures allow easy comparison between countries and provide a stable quantitative assessment of how an economy has performed. Yet, the same figures that make comparisons easy also obscure the features of the business and government activity that actually comprises the life of an economy—what gives it strength and vitality. In this book, my goal is to think about American prosperity, not just in terms of GDP but also in terms of some of the key features of the economy that, in my view, have underpinned its strengths and weaknesses. This book is organized around four characteristics of American-style capitalism: opportunity, entrepreneurship and innovation, wealth creation, and philanthropy.

I define these characteristics as currents, like currents in the ocean. Over time and space, currents shift with the changing contours of the ocean floor, shorelines, and other ocean currents. In the context of the American economy, none of the four “currents” I have described is a necessary or sufficient condition for economic growth. Rather, each current has played a vital role in shaping the unique prosperity of the American economy during certain periods in history, often aided by the strength of other currents, but not necessarily. The currents are interconnected, but sometimes the strength of one overshadows another, for better or worse.
The utility of this way of thinking about the American economy is that it allows one to critically examine the nature of the success that the American economy is experiencing at any point. For example, today I would describe the economy as experiencing high levels of innovation, high levels of wealth creation, and moderate levels of philanthropy—in many ways like the Gilded Age at the end of the nineteenth and beginning of the twentieth century. There are, however, questions as to whether the economic system is providing meaningful economic opportunities to all individuals. Thus, there is much to be optimistic about yet there is also room for caution.

The current metaphor provides a roadmap for thinking about each chapter in the context of the book. Chapters 2 through 5 work through each of the four major currents. Chapter 6 brings this analysis together, and chapter 7 assesses these currents in a comparative framework with other major countries in the global economy. Identifying philanthropy as one of the four major currents helps to elevate its importance much more than has previously been done in popular discussions of the American economy and American prosperity.
CHAPTER 2
CREATING OPPORTUNITY

[Some Americans define] economic freedom as an equal chance to become unequal.
—JENNIFER HOCHSCHILD

Four Thousand Years

For most of recorded history, civilization was pretty easily divided into two classes of people—let’s call them lords and peasants. The standard of living of each class did not change very much, and what change did occur was typically not noticeable within one lifetime. The lords generally preserved their wealth by coercion or rent seeking. Lords could choose war and plunder, or they could tax peasants for the use of their property, such as farmland or pastures. Tensions existed between lords and peasants, but if you wanted to move up, you had to stage a revolution.

Some lords were, of course, better off than others—they had more land and more political power—but even the poorest lord had the ability to collect rents because they owned property. Entrepreneurial lords could move up, so to speak, by acquiring more land, but this would require currying favor with those who made decisions about the