McKinsey Global Institute

Rethinking the future of American capitalism

American capitalism has evolved time and again, and we may be poised for another such shift. Will the future of capitalism involve tweaks, reforms, or wholesale change?

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Capitalism has contributed to significant gains in economic growth and prosperity throughout its history. But at a time of growing public discontent about rising inequality, heightened competition from economies with different models, and existential threats including from climate change, capitalism in its current form—and American capitalism in particular—may face its most serious test.

Talk of change had already begun prior to the COVID-19 pandemic. At a time when many are feeling left behind by globalization, the impact of technology, and other trends, and inequality has risen, critiques of capitalism in its current form have grown louder. The calls for reform—which range from tweaks to wholesale change—have come not only from economists but also from business leaders; for example, the US Business Roundtable, representing the CEOs of America's largest corporations, in 2019 redefined the purpose of corporations as going beyond serving shareholders to commitments to all stakeholders, promoting "an economy that serves all Americans." The pandemic has shone a harsh spotlight on challenges both old and new facing the American model of capitalism. Policy makers from across the political spectrum and business leaders, as well as leaders of multilateral institutions, have called for moves toward greater inclusiveness, resilience, and fairness.

Evolution of American capitalism would not be new. Indeed, capitalism has evolved in keeping with the changing nature of the economy itself, including the role of capital and labor, trade and monetary policy, and changing ideas about the political economy. The neoliberal model of capitalism present in the United States today and to varying degrees in other Western economies was shaped in the 1960s and 1970s. Commonly cited as a defining moment for this shift was Milton Friedman's 1970 article for the *New York Times*, in which he argued that "the social responsibility of business is to increase its profits." This itself was a move away from Keynesian economics, which emerged as the standard model in advanced economies after the Great Depression of the 1930s.

Today, we may be poised for another such shift. American capitalism faces the question of the nature and degree of change necessary to ensure growth and prosperity for all in the 21st century.

What follows is a brief recap of the strengths and the challenges. While by no means comprehensive, it serves to frame some key questions ahead.

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American capitalism has delivered unmatched growth and prosperity

America's brand of capitalism—the version that has been in place for the past half-century or so—has delivered unmatched economic growth and prosperity. GDP per capita has more than doubled over the past 50 years, while personal consumption expenditure per capita has almost tripled, and there have been significant improvements in longevity and leisure. The private sector—large and small businesses and entrepreneurship—is at the center of America's model of capitalism. In a forthcoming paper, we catalog the contributions that the private sector has made to American economic growth and prosperity. They include a fourfold increase in domestic business contribution to US GDP per capita, even as domestic business has declined from about 85 percent to 75 percent of net national income. Non-agriculture business activity accounts for 71 percent of value added of the US economy (excluding real estate) and 64 percent of employed labor income. As economic engines, businesses account for 83 percent of US technology investment, 76 percent of R&D investment, and 81 percent of labor productivity growth in the 21st century.

American capitalism has flourished by providing incentives for innovation and bold risk-taking by entrepreneurs and investors. It has fueled competitive markets, from which the innovations with the best market fit emerge and succeed, and it has created mechanisms for capital formation and investment to underwrite, commercialize, and scale the best ideas and propel the growth of the most successful companies. In addition to financing innovation in the private sector, large capital markets have been effective partners to government in moments of crisis and company distress, as has been evident in the COVID-19 pandemic. By scaling down or eliminating unsuccessful ideas and companies, American capitalism has also enabled a process of creative destruction and business dynamism unparalleled in other large economies, including those with capitalist models.

Although growth slowed in the first 20 years of the 21st century, America's model of capitalism has continued to lead in the global economy. While US real GDP growth has averaged just above 2 percent, it has outperformed the six other advanced economies of the G-7. The nation continues to lead the world in investment in research and development. Many of the breakthroughs fueling 21st-century growth, from digitization and artificial intelligence to innovations in the life sciences, have emerged from its ecosystem. And American firms rank among the most widely known and the most profitable globally: in economic profit, they make up 38 percent of the top 10 percent of firms and two-thirds of the top 1 percent of firms globally.

Benefits of the US model have not only accrued to the American economy and people but have spread around the world, through competition, trade, investment, and the proliferation of globally relevant innovations in areas like technology, medicine, and financial and capital markets, as well as in managerial and business model innovations. Rapid economic growth in emerging economies during the past 30 years has lifted a billion people out of poverty. This growth in prosperity is in large part due to effects of trade and participation in a global economy in which the American model and its related institutions and ecosystems have played a central role.

For participants in the American model, outcomes over the past 20 years have been positive for the innovators, entrepreneurs, and investors; the most innovative, fast-growing, and often large companies; the high-skill and high-wage workers; and the cities and dynamic hubs where much of this activity has taken place. Returns on investment, wealth accumulation and income growth, and overall standard of living for these individuals have continued to rise and even accelerated. However, for the rest of society—roughly the bottom three quintiles by income, which include about 150 million adults in the United States—the results in the past 20 years have been mixed, as we describe in the next section, and the effects of the COVID-19 pandemic have worsened those outcomes for many.

Now more than ever, the American model faces growing challenges, especially deteriorating outcomes and prospects for many individuals

Several challenges facing capitalism have become increasingly apparent in recent decades. Some come from within the system itself; others, from extrinsic challenges it must grapple with. Most have been brought into sharp relief during the COVID-19 pandemic. Many of the challenges we highlight are generally found in most advanced economies, but particularly in the United States.

Unequal and increasingly disparate outcomes for people and places

While inequality between countries has decreased, inequality within countries has increased, most acutely in the United States. Economic mobility has slowed, and the middle class that has been much celebrated as critical to the American economy has been especially squeezed, declining over the past half-century from 61 percent of American households to 52 percent. A primary source of this inequality is a fundamental change in the US economy from one driven by manufacturing to one driven by services and consumption, which has reduced the income available to workers, and this inexorable shift is unlikely to reverse itself. The unequal outcomes for individuals and households over the past 20 years become clearer when considered through the lens of individuals as workers, consumers, and savers, as we outlined in research earlier this year on the evolving social contract.

For workers, average wages in the United States grew by only 0.9 percent annually from 2000 to 2019. Labor market polarization toward high- and low-wage employment eliminated one million middle-wage American jobs. Median wages for middle-wage jobs grew by just 1.1 percent over that time, while median wages for high-skill and low-skill workers grew faster, at 7.3 percent and 5.3 percent, respectively. Labor share of national income has continued to decline, and wages have lagged behind productivity growth. And despite overall gains in employment and an expansion of income-earning opportunities before the pandemic, most of the jobs created have been in lower-wage occupations, often in the service sector. Further, most of the employment gains have been driven by alternative work arrangements and part-time work, increasing job and income fragility.

Consumers have benefited from improved access and lower prices for discretionary goods, especially traded goods such as electronics, appliances, and furniture. But rising prices of basic goods such as housing, healthcare, and education—which make up a large share of consumption for low-income households—have outpaced inflation, eating up 54 percent of any gains in income over the last 20 years for the average US household. Household

For about 150 million adults in the United States, the results have been mixed, and the effects of COVID-19 have worsened those outcomes for many.

Workers earning less than $40,000 per year accounted for more than 80 percent of those vulnerable to layoffs, furloughs, and reductions in hours or income resulting from COVID-19; a disproportionate share were women and people of color.

savings rates have fallen at a time when individuals have to save for longer retirements and assume greater responsibility for saving. Almost half of individuals in the United States over the age of 15 did not save for old age last year.

Many of these outcomes have come down hardest on particular groups of people. Younger people are having a harder time finding full-time employment, spend a larger share of income on basic goods and services, and save less than other groups. While access to employment has improved substantially, women still are paid only 82 cents per dollar earned by men. And the racial wealth gap is especially pronounced in the United States. In 2016, the wealth of the median white family was ten times higher than that of the median black family, and 7.5 times higher than that of the median Hispanic family. Such differences persist, even among college-educated individuals.

Geography matters, too: more than two-thirds of US job growth since 2007 has been concentrated in 25 cities and dynamic hubs, while low-growth and rural counties where 77 million people live had flat or falling employment growth even during the recovery from the last financial crisis. Research has highlighted wide geographical variation in intergenerational mobility.

The health and economic effects of the COVID-19 pandemic are exacerbating these inequalities between people and between places, with many low-income individuals either in high-contact essential jobs with greater health risks, or facing temporary or permanent unemployment. Low-wage workers earning less than $40,000 per year accounted for more than 80 percent of workers vulnerable to layoffs, furloughs, and reductions in hours or income during the pandemic; a disproportionate share were women and people of color. Black and Hispanic and Latino Americans are overrepresented in nine of the ten lowest-paid, high-contact essential services, exposing them to greater health risks.

Addressing inequality is both a social issue and an economic issue. Rising inequality in the medium term could contribute to reduced aggregate demand, as high-income families typically spend a lower share of their income than other groups. Economists and social scientists also argue that inequalities of wealth, income, and consumption can harm economic growth in the long run, by hindering educational opportunities, human capital formation, and intergenerational mobility. These are critical success factors for the innovation and opportunities that capitalist development itself seeks to propel.

Increasing superstar effects

Capitalism's effectiveness in directing capital formation toward the most promising investments has implications for market structure and concentration of economic power. Gains over the past 20 years have been concentrated in a small subset of sectors, including finance, real estate, technology, pharmaceuticals, and some business services. This concentration has driven strong wealth effects, through higher returns to holders of physical and intangible assets and capital. The "superstar" sectors of the past 20 years are less capital- and labor-intensive than those of prior decades, according to our research, and they have been more geographically concentrated, further driving inequality in income and wealth. In the United

States, just 6 percent of counties account for two-thirds of GDP output. Concentration of talent, intellectual property, and other intangible assets reinforce these geographically concentrated gains to superstar cities, from New York to Los Angeles to Atlanta, which have 40 percent higher GDP per capita than peer cities but also considerably higher levels of inequality.

Superstar effects have been most apparent with the growth of superstar firms. Globally, among firms with more than $1 billion in revenue, the top 10 percent of companies capture 80 percent of all economic profit. Many of the superstar firms are characterized by large investments in intangibles, high-skill workforces, and business models enabled by digital capabilities, and often a higher proportion of international sales. They frequently access inputs globally and offer products and services that are relevant to multiple markets. To be clear, it is tough to stay a superstar: nearly half of them fall out of the superstar ranks every business cycle and, of those that fall, 40 percent drop to the bottom decile. It should also be noted that the bottom 10 percent of firms of economic performance destroy nearly as much economic value as that created by the top 10 percent, and don't turn over as frequently as those at the top—which, some would argue, should happen in a well-functioning capitalist model.

The COVID-19 pandemic has further amplified these superstar effects. The top-performing firms are better positioned to weather the economic crisis, with greater access to liquidity and more diversified markets. Moreover, many superstar firms have stronger digital capabilities that have helped them thrive during the pandemic. Some lead in the innovation and services such as healthcare and the life sciences that are much needed as economies navigate through COVID-19. No wonder a basket of large, profitable firms has outperformed the market over the past ten months while the rest of the economy has struggled.

Declining investment in public goods and the shrinking role of institutions

Investment in public goods, from education, training, and skills for human capital development to foundational R&D and infrastructure, has declined relative both to what is needed to enable individuals to have equality of opportunity and participate fully in the economy and to what is required for productivity, growth, and competitiveness. Federal spending on education, infrastructure, and scientific research fell from approximately 2.5 percent of GDP in 1980 to less than 1.5 percent of GDP today. At a time when technology and other forces drive a greater need for workforce retraining, the share of workers receiving employer-sponsored training fell, while public funding for worker training and other labor market interventions has also declined. Private-sector investments in public infrastructure, including in the form of public-private partnerships, have also fallen over the past 35 years, and declined at an even faster rate following the 2008 recession. Investment in public goods, including infrastructure, health, and workforce skills, are critical factors which contribute to the competitiveness and productivity of an economy. The COVID-19 pandemic has in many ways highlighted existing gaps in the nation's public goods as a result of this declining public and private investment, from healthcare systems and employment safety nets to access to essential digital infrastructure and investment in basic scientific research. Many of these shortfalls in public goods have had disparate effects on demographic groups and localities in the US economy, and are often a function of the economic dynamism and activity in different places.

In addition, changes in individual outcomes have been propelled in part by the shrinking role of institutions, both public and private, which are cushioning individuals to a lesser degree from the effects of the forces at work in the economy. For example, employment protections are now lower, a higher share of healthcare and education costs is private, and guaranteed pension levels have dropped. This pattern of greater "individualization" of the social contract prevailed in the majority of the advanced economies we examined, despite differing market systems and levels of government spending.

Climate change and other global externalities

The COVID-19 pandemic has demonstrated the need for a dedicated effort by the public and private sectors to respond to both a humanitarian and an economic crisis, for example through coordinated investment in the manufacturing of personal protective equipment (PPE) or support for

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the most vulnerable workers and small businesses affected by lockdowns. The crisis thus provided a glimpse into the challenge that liberal market systems, like America's, can face in addressing large-scale and coordinated interventions in response to external shocks.

Climate change also poses a challenge to capitalism through potentially the largest disruption to the market economy. Addressing it will likewise require coordinated, collective actions by firms, governments, and individuals, not just within but also between economies, and likely at levels beyond what the market itself will drive in the time required to address it. American capitalism has so far been unsuccesful in putting a price on carbon and regulating it through a market-based intervention, such as a cap-and-trade program. The past five years have been the warmest on record, and regions worldwide have seen increased occurrence of flooding, extreme weather, and wildfires. Over the coming years, we will likely see global socioeconomic impacts that affect human beings and physical and natural capital, as well as economic systems. These impacts will be nonlinear as system thresholds are breached and have knock-on effects. Moreover, the impacts on society are likely to be regressive, affecting the most economically vulnerable segments of society.

Competition (and cooperation) with different economic systems

Trends over the past 50 years have largely played out in a global economy centered on Western democracies, with the United States at the forefront. But emerging economies, once viewed primarily as sources of affordable labor or resources, are emerging as large and competitive economies in their own right and proving more dynamic in some respects than the United States. This is leading to an increasingly multipolar global economy. This challenge is best exemplified by the rapid growth and global scale of China.

China has evolved to become a global economic power. It became the world's largest economy in purchasing-power-parity terms in 2014, and its nominal GDP has reached two-thirds of that of the United States. It is already the leading manufacturer in the world, producing 20 percent of global manufacturing output. Moreover, China has itself become a large market for consumption, with a population of 1.4 billion people and increasing prosperity giving rise to growth in domestic consumption that now contributes more to China's economic growth than exports. By 2030, the Chinese working-age population will account for 12 cents of every dollar of urban consumption worldwide. This large domestic market is also attracting companies from around the world, including the United States.

China's economy is intertwined with that of the United States in other ways. China today owns about 4 percent of US national debt, because of its large trade surplus and need to maintain foreign exchange reserves. Its system of state capitalism has started to produce companies that are competitive on the global stage and look to opportunities worldwide. The Fortune Global 500 list of the world's largest public companies for the first time in 2020 included more companies based in mainland China and Hong Kong (124) than in the United States (121).

Through extensive industrial policy, China is making large investments in R&D and innovations, and is starting to close the gap in its aim to become a technology superpower, in areas including advanced communications and 5G, artificial intelligence, and biotech, among others. Historically, the United States had led the world in technology research, development, and commercialization since World War II, and still does. However, US federal R&D funding as a share of GDP peaked at over 2 percent in the 1970s and has declined since, falling to 0.7 percent in 2018. American companies continue to expand private-sector investment in R&D, but their ability to compete in areas of innovation as well as infrastructure investment that requires long-term investment decisions, while meeting shorter-term market expectations, is already being tested.

The challenges facing the American model of capitalism in the 21st century in a multipolar global economy go beyond the United States. They will involve other large economies (and economic regions) and their companies in terms of where they compete and partner and in areas of trade, technology, economic alliances, as well as the nature of multilateral institutions that facilitate, govern, arbitrate, and regulate how the global economy functions. This evolving global economy poses new and complicated choices for the evolution of the American model and for other large economies and their corporations.

The next era of American capitalism

The 21st century provides remarkable opportunities for business and economic growth domestically and internationally. Our own research and that of others highlight many different opportunities for innovation and growth in the coming decades. The strengths of American capitalism could position the United States to take advantage of these opportunities. But for its individuals, firms, and overall economy to fully

American capitalism has evolved time and time again, and we appear to be poised for another such shift. The question is how big a change?

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How the American model of capitalism works is not set in stone and can evolve, as it always has, to meet the new opportunities and challenges.

participate in and benefit from these opportunities, America's model of capitalism may need to evolve if it is to remain the unmatched mechanism for delivering prosperity for all that it has been.

However, in any such evolution, it is important to retain the strengths of the current model, especially those that will be critical to capturing the opportunities in the decades ahead, and focus on addressing the weaknesses, such as the ones we have highlighted in this article.

In previous eras, new ideas emerged and institutional actors enacted a number of market-based mechanisms that attempted to address the issues that capitalism faced. Modern forms of intervention may be needed, given the growing and pervasive role of technology, the emergence of new business models, the growing importance of intangible assets, and the changing ways in which individuals participate in the economy as workers, consumers, and savers.

The magnitude of the economic shock brought about by the COVID-19 pandemic creates an opportunity to reconsider how well the current model works and the extent to which it is fit for the challenges and opportunities of the present and future. These include how to ensure capitalism is inclusive, how to evolve market mechanisms, where to apply them, the role of government and industrial policy, and the role of corporations in the 21st century in addressing societal challenges. Whether and to what extent America's model of capitalism will need to adjust to growing challenges and new economic and technological possibilities remains to be determined. However, answers to some key questions may help provide direction:

1. Where and how can the strengths of American capitalism be reinforced and broadened to fully benefit the growth and prosperity of all in the United States, and others beyond it, to fully capture the promise and evolving opportunities and possibilities of the 21st century?
2. What types and mix of market-based and non-market-based interventions can shift capitalism to provide opportunities and improved outcomes to all its participants while preserving the innovation and competition that enable growth and greater prosperity? What aspects of market design and redesign are needed in order to create well-functioning and inclusive markets fit for a 21st-century economy and its participants?
3. As technology, the growing importance of capital and intangibles, and globalization all affect labor markets, how can capitalism evolve to ensure that people—the majority of whom participate in the economy via their labor—prosper, through access to quality jobs, income, and dignity? As COVID-19 has further highlighted vulnerabilities for many individuals, what safety nets and transition supports are required going forward, and how can these best be provided?
4. How can capitalism ensure that all people and places in the United States have the opportunity to participate fully in the economy, especially those most adversely affected to date and at risk of being left behind in the future? What investments are needed and how should these be made?
5. How should the concentration of economic returns and the emergence of superstar firms, sectors, and cities be addressed? How can the benefits of these superstars—for example, the ability to make larger, more uncertain long-term investments in breakthrough innovation and the benefits to consumers from scale and network effects—be harnessed for wider

benefit, while the downsides including impacts on innovation, competition, consumers, and regional economies are mitigated?

6. To what extent is capitalism equipped to address a challenge like climate change with the required speed and scale? Where can market-based interventions be applied, and what role can governments and other institutions play to create incentives and enable coordination in order to address climate change?

7. What actions will ensure that American capitalism remains competitive and resilient in the global economy? What can be learned from other systems of capitalism, and what aspects that make the American system unique should be leveraged for continued growth and prosperity? What, if any, is the role of industrial policy?

8. How can capitalism ensure sufficient investment in public goods, such as education and other human capital investments, in public infrastructure including health infrastructure, or in fundamental R&D? How can these investments be made equitably across various socioeconomic and demographic groups and parts of the country? How should these investments be financed?

There are further questions to be answered, some of which we intend to contribute to through our research at the McKinsey Global Institute over the coming months.

How the American model of capitalism works is not set in stone and can evolve, as it always has, to meet the new opportunities and challenges. Business leaders, policy makers, social institutions, and individuals will all play a role in shaping the American model of capitalism in the 21st century.

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