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Can Capitalism Survive?

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Speech after the Dinner Given by President Grimsson
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Can Capitalism Survive?

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On behalf of the invitees to the conference here in Reykjavik I want to thank President Grimsson for inviting us to this grand dinner in his beautiful home and for the great hospitality he and his wife have shown us on this occasion.

The objective of the conference – the 2nd annual conference of the Center on Capitalism & Society and joint with the University of Iceland – is to identify and assess the consequences, over the medium-term future as well as decades ahead, of the fiscal and demographic developments looming ahead. Some of us wonder: if, in anticipation, some depression of asset prices is now overdue, and with it a marked scaling back of investment and employment, will there be repercussions on public support for various market institutions? Perhaps for capitalism itself (where it still prevails)?

I would like to take up briefly the more general question: what are the main threats to capitalism and what seems likely to be its future?

First of all, I argue that the paradigmatic welfare state designed by William Beveridge – the classical social insurance system – is *not* a serious threat. It's not a natural antagonist. (The sterner welfare system of Bismarck was altogether benign, since it was entirely employment-related.)

Gylfi Zoega and I made an econometric estimation of the relationship between the unemployment rate and its hypothesized determinants. The results implied that *increases* in government spending, say, on welfare entitlements – and thus in the tax rates on labor used to pay for it – do *contract* employment. (See Zoega's PhD thesis, a 1993 report of the OFCE and my 1994 monograph *Structural Slumps*.)

But, properly interpreted, that effect on employment is not permanent, not wholly so at any rate, as we were later to realize. The *long-run* effect might be nil. The explanation is that the tax-rate increase, in lowering after-tax wage earnings, decreases private saving, not just private consumption. As a consequence, private wealth would begin to decline (relative to its original path) and might go on declining until it has regained its former ratio to the after-tax wage. Then, with the net-wage-to-wealth ratio *back up* to its original level, employment would likewise be found back to its original level.

There is a complication: the increase of social insurance benefits constitutes an increase in what I call social wealth. Private wealth is down, but social wealth is up. As a result, it could be that there is in the end a remaining negative effect on employment. But my empirical studies do not suggest it is terribly large. What could be serious for an economy is heavy taxation by the country of investment activity and of corporate income. That would weaken investment and innovation.

A further complication in which the welfare state is involved is the subject of our conference: the failure to fund fully the pensions of the baby boomers and, in the US, the failure to curb the runaway expenditures on medical care for the elderly have exacerbated the increase in tax rates that will ultimately be needed over the future and the weakness of exchange rates required to push out the necessary exports. Pay-as-you-go is very bad.

I believe, however, that the principal antagonist of capitalism in the world today is *corporatism*, not the welfare state. I argue that the corporatist thinking that began to emerge more than a century ago and the corporatist institutions that grew up in the Interwar period do great damage to the economies of continental Europe – rendering some of them a sort of “still life” of capitalism rather than the living thing. (I have in mind western continental Europe, but the eastern part is not much different.)

Corporatism, as a system of *economic thought*, has three stands, as I see it – all of them inimical to capitalism. Indeed, each is a reaction to capitalism.

One strand is what I will call *scientism* or *rationalism*. It is the idea, which took hold in the 1920s and 1930s, especially in Italy and to a lesser extent in Germany and a few other European nations, that a country will see faster economic progress (and a higher level of economic activity as a result) if it pulls resources together in a coordinated way to make scientific and engineering advances than if it relies on the small-minded entrepreneurs of the petit bourgeoisie. We see this idea expressed by the fast trains depicted by the *Futurismo* painters, the powerful mass gatherings evoked by Orff and Respighi, and Riefenstahl's film The Triumph of the Will. So ingrained was this thinking by the 1950s and 1960s that Milton Friedman's *Capitalism and Freedom* and Henry Wallich's *The Cost of Freedom* declined to say that the GNP of the Soviet Union would not overtake that of the United States. For Wallich, the capitalist countries would have to console themselves with the greater personal freedom that capitalism engenders – which, for him, was the sole remaining justification for capitalism.

Another strand, which came to be called *Christian corporatism*, interweaves the anti-materialist and anti-bourgeois strains of 19th century social thought – from the anti-Enlightenment philosophers Justus Möser and Johann Gottfried Herder early in the century to Charles Maurras and Pope Leo XIII toward the end. This devaluation of wealth and work appears to be influential on the European continent even to this day. The Munich economist Hans-Werner Sinn told me once that a German would rather say that he had inherited his wealth than admit that he had worked for it. This must make a difference. One does not have to be very materialistic or from the middle class to be a capitalist entrepreneur or financier. However, the attitude that private wealth is not to be respected and the commercial class is to be looked down on is surely inhospitable to profitable entrepreneurial activity. When a German minister recently called hedge funds "locusts" he was speaking in this tradition.

The last strand in corporatist thought arose in the 1920s in response to the mounting industrial strife and the red scare in much of the world. Private ownership could remain in an industry, subject to its performance and conduct. But business activity was subject to a kind of consent, which might be called *solidarism*. Institutions should be set up to foster the agreement among the interested parties to any business activity – between capital and labor in an industry and between industry and community. (Each industry or profession was represented by a body (*corporazione*) that would bargain with employees, communities and the government.) In the decades after World War II this thinking went farther. Italy introduced *concertazione* giving the labor unions power to block government proposals before they went to the parliament; and Germany introduced *Mitspreche* giving employees a voice on operations (and ultimately investment decisions) in corporate boards. In the postwar decades, the new terms *social partners* and *social market economy* had to be coined to designate the novel economy that had evolved.

On the Continent, corporatist economies were instituted in steps from the ’20 to the ‘60s. Is capitalism still losing ground in the West? As I see it, the “Anglo-Saxon” nations are not a safe preserve for capitalism. In Britain, profits are not very popular, entrepreneurs not very admired and community opinion can be harsh. (Keynes was something of a corporatist.) In the United States, the encouragement of competition and new entrants appears to have waned. The premise of public advocates is increasingly that the capitalist system, in which firms seek only profits for their owners, is of no social value and can be redeemed only by corporations taking on an activist social role. It isn’t enough to obey the law and heed fiduciary obligations. The premise of the Sarbanes-Oxley law is that the free hand that capitalism gave to CEOs to act on their (barely verbalized) visions was not in the public interest, as it was hazardous to stakeholders The direction, then, appears to be toward corporatism – though capitalism has had some good innings.

But is capitalism better than corporatism? Yes. To begin: The system that has evolved called capitalism is an economy of considerable *dynamism*: its “spirit” and its institutions welcome change and foster innovation, generally with due regard for profitability. This dynamism is thanks to its reliance on pluralism of entrepreneurs, each with a new idea or “model,” and pluralism of financiers rather than the consensus of the state, region or community; its appeal to the market rather than to community and social partners; and its appreciation of work and wealth rather than devaluation. (Its acceptance of individual luck and high achievement also helps.)

Further, this dynamism is essential for the *highest level of economic performance*. A high-performance economy is so structured that its participants generally have a sense of *prospering* and of *developing*: this means in turn that the available jobs are rewarding in more than pecuniary ways and that such jobs are in ample supply. In high-productivity, thus high-wage economies, the sense of prospering comes not only from the paycheck but from activities at work that *engage the minds* of the jobholders and *enlist them in problem solving*. The sense of developing – of ongoing development – comes from jobs that lead people to *discover some of their talents* and to *expand their capabilities*. If so, it is clear that for high performance an economy must have the dynamism continually to generate change and to throw out new problems to be solved.

Finally, though such qualities in jobs are hard to measure directly, intellectual stimulation and personal growth in the job promote high participation in the labor force, which is measurable; and if they raise job attachment, they also lower unemployment, which is also measurable. The data show that the economies we think of as highly corporatist – Italy, Germany and the Netherlands, for example – have generally lower participation rates and higher unemployment rates than the countries we think of as relatively capitalist – the U.S., the U.K. and, now, Ireland. This is *circumstantial evidence* that the economies high on the capitalism scale enjoy *more dynamism* than the economies high on the corporatism scale.

It is not the case, then, that corporatism in the advanced industrialized economies performs as well as capitalism. The corporatist economies' Glorious Years (from the late '50s to the mid-'70s) could occur because their institutions were dynamic enough to accomplish the approximate catch-up to the U.S. Few institutions would not have been. But they were *not* dynamic enough to keep up with the innovations of the ICT revolution in the '90s and to adapt to the wave of competition from the east in the present decade.

I conclude that the Continent's rejection of capitalism in favor of corporatism was a tragic error. But that may not be recognized soon, if ever. In the meantime, corporatism's ideas may spread wider over the West.

TABLE: Inter-country difference in employment among member countries of the OECD and inter-country differences in the tax on labor.[1]

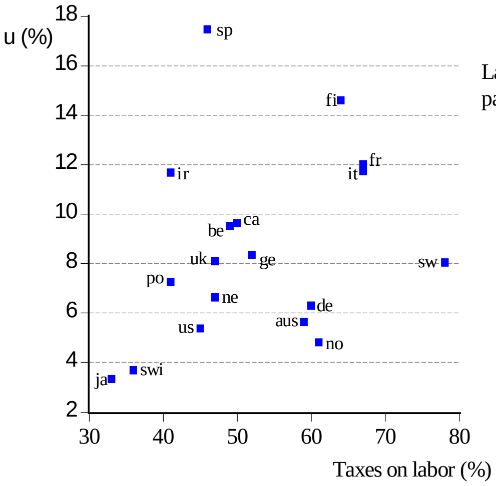

Figure 1a. Taxes and unemployment.

Unemployment (OECD) is measured in 1996. Taxes are taken from Nickell (2003) and measure the sum of payroll tax rates, income tax rates and consumption tax rates. Taxes are calculated for the period 1988-1995.

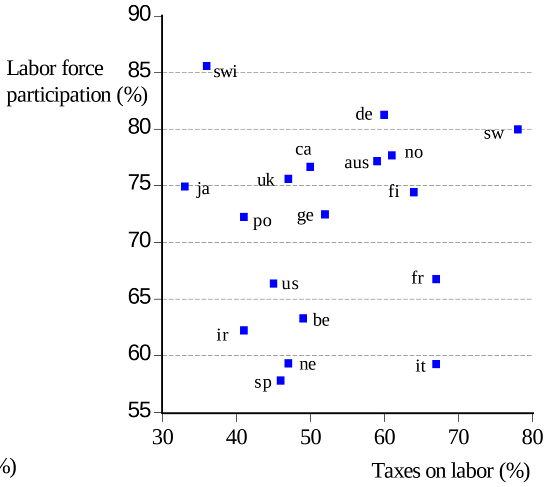

Figure 1b. Taxes and labor force participation.

Labor force participation (OECD) is measured in 1996.

[1] These charts or similar ones appeared first in Phelps and Gylfi Zoega, "Natural-Rate Theory and OECD Employment," *Economic Journal*, 108, May 1998, 782-801. They were updated in Phelps and Zoega, "The Search for Routes to Better Economic Performance in Continental Europe," *CESifo Forum*,.Spring 2004, 3-11.

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