Protecting capitalism from itself

Published in D!ssent Number 44, Fall 2014

Ian McAuley, University of Canberra and Centre for Policy Development

> Let me be frank: in the past economists have underestimated the importance of inequality. They have focused on economic growth, on the size of the pie rather than its distribution. Today, we are more keenly aware of the damage done by inequality. Put simply, a severely skewed income distribution harms the pace and sustainability of growth over the longer term. It leads to an economy of exclusion, and a wasteland of discarded potential.

Imagine if Opposition Leader Bill Shorten had said that. The tabloid headlines would scream about "class war" or "the politics of envy". In this land of plenty and the "fair go" there is still a taboo about talking about inequality.

In fact it is an extract from the 2014 Richard Dimbleby Lecture by International Monetary Fund (IMF) Managing Director Christine Lagarde. The IMF hardly has a "left" reputation – in recent times it is best known for the tight fiscal conditions it has imposed on governments to which it has made loans.

It's easy to forget that the IMF was established as a key institution of the postwar liberal order, the groundwork of which was laid 70 years ago at a gathering at the Mount Washington Hotel in Bretton Woods, New Hampshire, where the soon-to-be victors of the war met to work out a postwar fiscal and monetary order. Australia was represented by Sir Leslie Melville – later to become Vice-Chancellor of the Australian National University, but the overwhelming presence was the UK delegate, John Maynard Keynes.

By tapping into that background Lagarde reminds us of the conditions that led to the disasters of the first half of last century – forty-one years of armed conflict leaving 100 million dead, including 90 000 Australians.

On the mind of delegates at Bretton Woods was the failure of the European powers to establish an enduring peace after 1918. Almost every country in the then "developed" world suffered some form of economic collapse, ranging from the hyperinflation of the Weimar Republic in Germany through to the Great Depression in other countries with capitalist economies. Australia's unemployment rate reached 30 per cent in those years. In the USA Roosevelt's New Deal, a massive program of public works, softened the effects of the Depression, but it was only the mobilisation of wartime that really pulled economies out of the mire.

The immediate concern of the Bretton Woods delegates was to prevent the re-emergence of beggar-thy-neighbour protectionism, but there was a more general concern about the domestic economic order in capitalist countries. The most alarming but realistic scenario was a collapse in economic activity with the ending of war production, austerity as a response to war debt (Australia's government debt was 130 percent of GDP), and a bitterly discontented, war-hardened, demobilised and unemployed army, ready for revolution. It's easy to forget that until the early 1950s Australia had a thriving communist party.

As Roosevelt had realised when he pursued the New Deal, if capitalism were to survive it had to be protected from its own tendency to self-destruct. From different perspectives both Karl Marx and Henry Ford knew that capitalism could destroy its own markets if workers were underpaid or unemployed.

More generally, in democracies, the economic order rests on its electoral acceptance. Unless there is a clear link between contribution and reward, the economic system lacks legitimacy and loses support. As the history of countries as diverse as Argentina and Russia shows, when people reject an economic order they are likely to choose something worse. Economic discontent is a breeding ground for populists and revolutionaries.

Australia's postwar economic order was based on this understanding. In 1945 it was formally articulated in the Keynesian-inspired *White Paper on Full Employment*, which, as its name suggests, stressed full employment as a prime policy objective, but which also emphasised the need for pensions and, most importantly, government services including "education, health and medical services, kindergartens and libraries" – generally known as the "social wage". Although drafted by the Chifley Labor Government, its philosophy was embraced by the Menzies Government and was given new life in the Hawke-Keating Government's Accord.

In Australia we didn't play by all the rules of Bretton Woods. We were tardy in reducing tariff protection and in liberalising financial markets, which meant that as a small country we could free-ride for a while off liberalisation in other countries. High immigration provided both labour and a source of demand to keep our economy thriving, and by around 1970 we realised that our huge continent had a treasure of mineral wealth.

While Australia was a standout success in the postwar era, other industrialised countries followed a similar path of low unemployment, rising living standards, and greater equity in income distribution. The Bretton Woods order was working.

The end of the postwar order – inequality again on the rise

The Bretton Woods arrangements started to unravel in 1973, because in order to ensure stability they had included a regime of fixed exchange rates – an unsustainable arrangement when different economies have different growth paths. Unemployment and inflation rose sharply, and governments floundered with policy prescriptions – for example even the USA for a time tried to implement widespread price controls.

While the crisis of 1973 was precipitated by a sharp rise in the price of oil and abandonment of a fixed gold price, it was the emergence of industrialisation in so-called "developing" countries which was to have the greatest economic consequences. The Bretton Woods agreements on trade and investment liberalisation had spurred industrialisation in those countries, and at the same time there were developments in transport and communication technologies, including shipping containerisation.

In countries like Australia and the USA we saw manufacturing jobs, once a basis of well-paid employment, move offshore – a development still playing out as we see our car industry finally closing down. The developments which spurred world-wide prosperity and an era of peace among once-warring nations, had as a by-product the loss of well-paid industrial jobs in the old "developed" countries. Globally of great benefit, locally a significant problem.

From the1980s until the economic crisis of 2008 economic growth resumed, but on a different basis, and as well-documented in works by Robert Reich in the USA and Andrew Leigh in Australia, inequalities started to open up once more. Measures of inequality vary – for example inequalities in wealth take longer to develop than inequalities in income – but by now most of the gains of the postwar years have been reversed.

It has taken time for inequalities to show up, because for many years people were able to keep up their living standards by running up debt, particularly through financial innovations such as credit cards and later on through mortgage re-draw facilities – a set of innovations which led to growth in the financial sector and which would contribute to the crisis of 2008.

In Australia there was the commodity boom of the late 1990s, as new mining investment flowed into the country, allowing the Howard-Costello Government to dispense middle-class welfare through family allowances, funding of private schools and subsidies for private health insurance. Thus, for a time Australia avoided the US phenomenon of a hollowing-out of the middle class. The Government dispensed largesse by allowing debt to accumulate – not government debt which would show up on public accounts – but private debt which would show up on household accounts and on our overseas debt ledger, and as unrecorded liabilities through neglect of needed investments in education, infrastructure and industry modernisation.

At the same time there was a boom in housing prices. My enduring memory of the evening of John Howard's 2004 election victory, for example, was a roving TV reporter's interview of a young man who said "Of course I voted for Howard: three years ago my house was worth only $300,000; now it's worth $500,000. I'm $200,000 wealthier thanks to the Government."

Conscious of widening income and wealth disparities, the Rudd-Gillard Government made modest steps towards closing the gap through raising the tax-free threshold and cutting back on middle-class welfare. Some changes, such as taxing earnings on high "self-funded" pension incomes and closing tax rorts for employer-provided cars, didn't make it to legislation, and the Government showed little enthusiasm for a return to the idea of a "social wage" in provision of government services.

The major shortcoming of the Rudd-Gillard Government, however, was that apart from a late commitment to school funding reform, it didn't really address the fundamental structural causes of widening inequality. Like the Howard-Government before it, its focus was on redistribution (admittedly more equitably) rather than on the way the economy could distribute benefits without being so reliant on the levelling interventions of government through tax and social security to compensate for disparities in market income.

The distinction between *distribution* and *redistribution* is important. An ideal outcome, unattainable but worth keeping in mind, is an economic structure in which everyone has an opportunity to participate and to be adequately rewarded, with no need for any redistribution through cash benefits or progressive taxation. Countries like Australia and the USA came closest to that ideal in the postwar years, although even in those times of near full employment there was heavy reliance on progressive income taxation to ameliorate inequalities. In those years too, when life expectancy was lower, demand for age pensions was low, and the population was kept young through high immigration. There will always be a need for redistribution, but by most economic criteria it is best to have an economic structure which ensures that there is a reasonable distribution of income before the government kicks in with redistributive taxes and pensions.

In this regard the policy of the Abbott Government is far from clear. Its initial moves to halt the redistributive reforms of the previous government, its unenthusiastic reception of education funding reform and its hard language about “the age of entitlement” being over, all suggest a lack of concern for redistribution – in fact it reveals a concern to preserve privileges already favouring the well-off. Maybe they’re acquitting a political debt to generous and loyal supporters. Maybe they’re simply revealing economic incompetence. Maybe they’re engaged in a class war, a vendetta against unions and all they stand for – note that we no longer hear ministers talk about the merits of an economy capable of paying high wages. Or maybe they’ve embraced Reagan’s “supply side” economics, the notion that the rich will invest and build up the productive base of the economy – a belief related to the idea that material wealth and virtue are inseparably linked to each other.

Whatever the source of the present government’s policies, it is apparent that equity isn’t high on their agenda.

Where we are now – four threats to order and prosperity

Inequality hasn’t led to rioting in the streets. As we know from the history of the French and Russian revolutions, people have to be driven to extreme deprivation before they resort to rebellion.

Inequality’s threats to order and prosperity in an advanced democracy are more insidious, are likely to occur over an extended period, and are in the form of lost opportunity – we won’t become fully aware of them until one future day historians tell their classes and old people tell their grandchildren that there was once a time when Australia was a prosperous democracy.

For the sake of presentation I outline four threats, but they are interrelated. Other authors use different structures, but whatever framework is used the analysis leads in the same direction.

The first threat is the *intellectual rationalisation we use to ignore inequality*. A belief among many free-market economists is that while allowing markets a free run results in inequality, that is a minor cost to pay for the resulting general prosperity. Indeed, it may not be a cost at all, because, as the saying goes “a rising tide lifts all boats”.

The “rising tide” idea finds its intellectual rationalisation in the philosophy of the economist Wilfred Pareto – a philosophy that has become widespread in our universities and among economists in the public service. It’s a bare-bones philosophy, which says that one cannot compare different people’s welfare. Most people, blessedly unschooled in economics, may believe that overall social welfare is improved if, say, some policy intervention such as progressive taxation were to take $1000 from Gina Rinehart and give it to an unemployed single mother, but Pareto economics says that we cannot make such a judgement because we cannot make such interpersonal comparisons. We can claim an improvement in welfare only if some are made better off while no one is made worse off. Therefore a gift of $1000 to Gina Rinehart while giving nothing to the single mother is a Pareto improvement, as would be a gift of $1000 to the single mother while giving nothing to Gina Rinehart, but we cannot say one outcome is preferable to the other.

While the Pareto rationalisation provides a neat cop-out for anyone defending the existing order, it's bunkum.

No-one likes being left behind. There are plenty of older Australians, particularly those who grew up in the country, who can recall childhood conditions which today would be classified as material deprivation, in houses without electricity, bathrooms or telephones, but their families never considered themselves poor, because they were the standards of the time. We reasonably expect to be able to keep up with rising standards.

Also, although it may be possible for academics and public servants to talk about Pareto improvements, in practice they are hard to achieve. In many situations tradeoffs between groups are unavoidable: there have to be losers. Decisions over the last 15 years to subsidise people to take private health insurance provide a case in point. When some are helped to get to the front of the queue others are pushed back along the queue. As long as there is a constrained supply of surgeons and other specialists any move to help some get faster access are to the disadvantage of others. So it goes for other goods in constrained supply – "positional goods" in the language of economists.

The days when public policy could be developed inside a "no losers" framework are probably well behind us. When our per-capita GDP was growing at two to three percent a year, Pareto outcomes were comparatively easy. With lower economic growth, or even stagnation, we will have to confront the need for tradeoffs, but the Pareto principle gives no guidance for dealing with shared sacrifice. So far politicians in the main parties have assiduously avoided mentioning that necessity.

The second threat comes from the *fiscal (and moral) unsustainability of the usual means we have to deal with inequality* – through paying pensions and other allowances to the poor.

The economic philosophy is that even if a few boats are left stranded, or if society finds relative poverty too indecorous, strong economic growth will ensure there is enough tax revenue to provide social security to bring up the standards of the poor.

That looks neat on paper, or on the whiteboard of a classroom at the University of Chicago, but it has a number of shortcomings.

One is that taxes do not necessarily flow so freely. Businesses and wealthy individuals are adept at avoiding tax. Australia, in particular, has a very weak tax base, and there are no politicians in the main parties willing to raise the issue. In countries like Australia increases in social security payments are made not by increasing taxes but by squeezing other public expenditure in areas such as education, health care and infrastructure. The resulting under-investment in these essential public goods eventually weakens the economy.

Even if cash handouts can be sustained, they never take the place of the opportunity to participate in society through meaningful contributions, making full use of one's capabilities.

The oil-rich economies of the middle east – Saudi Arabia, Kuwait, Qatar and the UAE – have plenty of money, but they face a huge challenge in social inclusion. Inequality isn't just about differences in material living standards: it's also about inequality in respect, dignity, status and opportunities for participation. That's the moral unsustainability of the welfare state based on cash compensation – these benefits cannot be distributed with handouts.

The third threat, related closely to the previous one, comes from a *waste of human capital*. As time passes inequalities in income translate into even wider inequalities in wealth, and therefore into intergenerational privilege and intergenerational deprivation. Social mobility, an essential condition for meritocracy, is reduced. Financial wealth, which should be put to use in investing in the nation's productive capacity, comes into the hands of the indolent or incompetent rich, who either invest it unwisely or blow it on luxury consumption. At the other end of the spectrum the wealth of human capital is never realised as children grow up in dysfunctional households and miss out on those educational opportunities which would allow them to develop their capabilities. Both entrenched privilege and entrenched poverty weaken a capitalist economy.

The fourth threat, which arises from the other three, is a *loss of the economic order's legitimacy*. That was the threat in the 1930s, and it is the threat to which Lagarde is undoubtedly referring. When people no longer see any connection between contribution and reward, they become cynical and disillusioned. When people believe that whatever their contribution, the rewards will go to others, productivity suffers. The work culture shifts from enthusiasm to sullen compliance or even subtle sabotage as workers take it out on their bosses, who, in return, implement ever more burdensome supervision and performance systems. In relationships with government tax evasion and welfare fraud become more widespread as people try to recover what they believe to be their rightful share. A shared belief that economic arrangements are fair is a basic part of a nation's social capital, making for trusting and low-friction relationships between workers and employers, creditors and debtors, customers and suppliers and between taxpayers and governments.

The cynicism that arises from a sense of unfairness is not quelled by minor adjustments to allowances such as increases in the Newstart allowance or by handouts to struggling groups, such as the current Government's assistance to debt-laden farmers. When there is a widespread belief that there is a class of people whose prosperity results from political privilege – "rent seekers" in the language of economists – cynicism becomes entrenched. This cynicism is reinforced by reports of outlandish executive salaries and perks, and by displays of ostentatious vulgarity by the rich.

When a sense of economic unfairness sets in the disillusioned and cynical become easy prey for populist politicians. That discontent does not flow to support for the traditional socialist, social democrat and labour parties of the "left". Rather, where economic discontent is worst, where people are most disconnected, it fuels the prospects of political parties on the extreme ends of the spectrum – parties which in their own ways bring about economic misery and oppression. That's the history lesson of the twentieth century – well understood by those who met at Bretton Woods in 1944, but now fading from our political consciousness.

In Australia as yet we have no equivalent of the European neo-fascist or resurrected communist parties, but we do have a drift of political support to fringe parties – in the 2013 election the poorest electorates with the lowest standards of education recorded support up to 25 percent for the Palmer United Party and other fringe groups. The Labor Party, which should be attracting such voters, has been weakened by its dysfunctional organisational structure, by a the partisan Murdoch media, and by a Liberal Party more concerned with destroying its rivals than with governing the country. By now Labor seems to be too timid to talk about equity – afraid perhaps that a concern for fairness will be represented as a desire for levelling, or as a call to arms in a class war.

Maybe the present Government can stave off disillusionment for a year or two, by resuming the Howard-Costello policy of allowing liabilities to accumulate while we live beyond our means, and falsely claiming competence in economic management. When this economic strategy is seen to fail however, triggered perhaps by a currency or inflationary crisis leading to a sharp rise in unemployment or living costs, Australians will seek to vent their annoyance at the ballot box.

That’s why we need a political party to offer a responsible economic alternative – a reformed and reconstituted Labor Party, a Liberal Party with the insight to recognise the destructiveness of its present policy path, a Green Party with a broader base than the inner city, or a new centre-left party capable of offering an economically responsible alternative. Otherwise the electorate is likely to follow populist prophets and later this century ageing Australians, like ageing Argentinians, will be looking back on a time when their country was a prosperous democracy.

Whether that party emerges from the “right” or “left”, it needs to have a set of policies which protect capitalism from its own tendency to self-destruct. It needs a platform for fairness.

A platform for fairness

Our opportunity to avoid economic self-destruction lies in our capacity to raise public revenue to reduce inequality. Those who stand to prosper from privatisation and a general retreat of government have led a deceitful campaign convincing us that we live in a high-tax country, but the reality is that of all prosperous countries Australia has one of the lowest levels of taxation. At 28 per cent of GDP, our taxes are well below the OECD average of 34 percent of GDP, and much lower than taxes in some northern European countries where they reach 45 per cent of GDP.

It isn’t that Australia has particularly low tax rates. The only area where our rates are significantly lower than in other countries is in consumption taxes – our general consumption taxes (the GST), alcohol and gasoline taxes.

Where we do stand out in relation to other countries is the generosity of tax concessions – for superannuation, retirement incomes, health insurance, capital gains on short-term investment, housing (both owner-occupied and investment), family trusts and the absence of inheritance taxes. These have built up incrementally – as mentioned above they have been designed to preserve the incomes of the middle class, which both main political parties have tried to keep on side. Such concessions have favoured older Australians, to the disadvantage of the young, who have faced increases in university fees and more expensive housing and have been cajoled into private health insurance to pay for the health care of the aged.

If a sacrifice is to be made, it has to come from this privileged class – a class which undoubtedly includes many *D!ssent* readers. Of course we need a tax net to catch those on the BRW rich list and a crop of overpaid corporate executives, but that's more about restoring a sense of legitimacy than raising revenue. Even if an extreme left government were to confiscate all the assets of the ten wealthiest Australians and redistribute them to the other 22 999 990 Australians, it would be a once-off redistribution of only $3000.

The lazy way to spend such restored revenue would be to increase social security payments significantly, but at best that would attend only to material living standards and its benefits would be short-term .

Rather, we need to channel those funds into investment, particularly in education, health care and environmental protection. To quote again from Lagarde, during her recent visit to Australia for the G20 Finance Ministers' meeting:

> Investing in health, investing in education, making sure there are equal opportunities for all, is something where public money is needed ... it is not a question of entitlement.

These are sound investments, particularly in a world where we must increasingly live by our wits, where the most valuable asset of capitalism is human capital. The capitalism of this century is not the capitalism of the nineteenth century – a model which still dominates our thinking and institutional arrangements. In the nineteenth century the owners of capital, as Marx understood, were those who owned expensive machines, ships and railroads, while labour was a plentiful and only basically skilled commodity. That world is well behind us. In many industries the cost of capital equipment has tumbled.

As the twenty-first century Marxist economist Jerry Muller points out, the capitalists of today are those with human capital – the set of skills, education, experience and socialisation that allow one to thrive in a competitive economy. They do well for themselves, but those without such assets are in the same situation as the labourers in the factories of the nineteenth century – worse off in many ways because they lack the solidarity which allowed effective unionism to develop.

The industrial transformation of this century, wrought by changes in information and communications technology, has only started to show its effects. Carl Frey and Michael Osborne of Oxford University have recently published research showing that transformation of the service sector – the sector that accounts for at least three quarters of our economy – has barely begun, and will soon be reaching into professional occupations. Occupations as diverse as bus drivers, real estate agents, economists and lawyers are under threat. Universities, for example, are now confronting the emergence of MOOCs – Massive Online Open Courses.

Governments can delay such transformations. The present Australian Government, for example, is doing all it can to protect the coal and timber industries, and is scaling down the extension of broadband to delay industrial transformation. If our Government does succeed in preserving an obsolete economic structure, as Argentina did early last century, our future will be a slow slide into poverty.

If, however, we are to resume the path of economic adjustment, there will be short-term costs to finance an investment in human capital. Otherwise we would face the cost of a growing impoverished underclass, loosely attached to the economic and social life of the community, and making big demands on public resources – social security, health care, policing, and the cost of lost economic contributions (“opportunity costs”) as we face shortages of those skills needed in the emerging economy of this century. To finance that investment we need to draw on those who have done so well in recent years.

Of course there are political difficulties in removing privilege, even if it has been unearned and undeserved. We should never underestimate the capacity for the well-off to find rationalisations to justify their privilege, but they need to be reminded of the future they, and more particularly their children, face if they do not make the requisite sacrifices now.

To bring the well-off on side, they need to become re-connected with and share in the lives of other Australians. There has always been a degree of geographic segregation in our cities – Sydney’s north shore and Adelaide’s eastern suburbs are isolated from the far-flung outer suburbs and even more isolated from outback poverty. Growth of private schooling, and use of private hospitals adds to this isolation. Increasingly we find that the well-off are living in virtual (and in some cases real) gated communities. Also, with the decline in religious observance there is one less opportunity for social mixing.

As a consequence, this class feels it has less stake in funding public services, and can easily be blind to the hardship endured by others. Surveys of the well-off, asking where they believe they fit on a comparative scale of income or wealth, always show that they believe themselves to be much further down the scale, much closer to “average”, than they actually are. Successive Labor Governments, both state and Commonwealth, have made much of social inclusion, but they have been concerned with social inclusion only at one end, neglecting social exclusion by the well-off, and actually pursuing policies in education and health care that add to such social exclusion.

The call to re-establish a sense of social solidarity and fairness is not some far-out “left” campaign. In fact it aligns with a traditional “right” concern to see a connection between contribution and reward – a connection badly weakened in recent years by the ease with which rent-seekers and those who resist economic change have been able to shape public policy. The call comes from those who want to see capitalism’s best aspects, particularly its adaptability and its capacity for innovation, retained, but who are also aware of its capacity to self-destruct when greed displaces common sense and norms of social morality.

Lagarde’s warning on the economic threat posed by inequality has been one of many to come from economists in recent times – most prominently Paul Krugman on the “left” and Baron Robert Skidelsky on the “right”. If , in our Parliament, those voices fall in deaf ears, perhaps the many Catholics on both sides of the floor may be encouraged to heed Pope Francis’s Lenten Message:

> When power, luxury and money become idols, they take priority over the need for a fair distribution of wealth. Our consciences thus need to be converted to justice, equality, simplicity and sharing.