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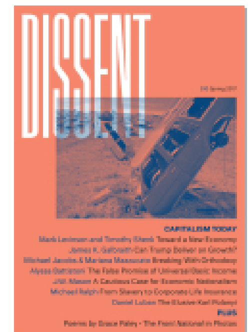

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Breaking with Capitalist Orthodoxy

Michael Jacobs and Mariana Mazzucato

The capitalist economies of the developed world have, over the last decade, proven to be profoundly dysfunctional. Not only did the 2008 financial crash lead to the deepest and longest recession in modern history, but nearly a decade later, few advanced economies have returned to anything resembling stability. Prospects for growth remain uncertain. Even during the pre-crash period when economic growth was strong, living standards for the majority of workers in developed countries barely rose. Inequality between the richest and the rest of society has now grown to levels not seen since the nineteenth century. Meanwhile, continued environmental pressures, especially climate change, threaten global prosperity.

The financial crisis came as a shock not only because few had predicted it. It also went against the mainstream wisdom of the previous decade that policymaking had solved the fundamental problem of the business cycle; major depressions were supposed to be a thing of the past. Economic policy since the crisis, however, has been no more successful. The orthodox prescription of fiscal austerity—cutting public spending in an attempt to reduce public deficits and debt—has not restored Western economies to health, and economic policy has signally failed to address the deep-rooted and long-term weaknesses that beset them.

We need to better understand how modern capitalism works—and why, in key ways, it now doesn't. So, first we examine Western capitalism's failures, in particular, three fundamental problems that have led to its current weak performance: weak and unstable growth; stagnant living standards and rising inequality; and environmental risk and climate change. We then conduct a reappraisal of some of the dominant ideas in economic thought, which we believe can inform new policies that can more successfully tackle the challenges of capitalism today.

Weak and unstable growth

The scale of the 2008 crash can hardly be exaggerated. In 2009 real gross

domestic product (GDP) fell in thirty-four of thirty-seven advanced economies, and the global economy as a whole went into recession for the first time since the Second World War. Between 2007 and 2009, global unemployment rose by around 30 million, over half of which was in advanced economies, including an increase of 7.5 million people in the United States.

To prevent an even bigger crisis, governments were forced to put unprecedented sums of taxpayers' money into bailing out the banks whose lending practices had precipitated the crisis. In the United States, the Federal Reserve had, at its peak, $1.2 trillion of emergency loans outstanding to thirty banks and other companies. In the United Kingdom, government support to banks in the form of cash and guarantees peaked at £1.162 trillion. At the same time, governments undertook major stimulus measures to try to sustain demand as private spending and investment collapsed. The huge drop in output and the rise in unemployment led to large increases in public deficits as tax revenues fell and the automatic stabilizers of welfare payments and other public spending took effect.

The financial crash exposed fundamental weaknesses in the functioning and regulation of the global financial system. As former Chairman of the Federal Reserve Alan Greenspan grudgingly acknowledged in his testimony to Congress in 2008, there had been a "flaw" in the theory underpinning deregulation. The presumption that "the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms" had proved incorrect. Contrary to the claims of the "efficient-markets hypothesis" that underpinned that assumption, financial markets had systematically mispriced assets and risks, with catastrophic results.

The financial crash of 2008 was the most severe since that of 1929. But as economists Carmen Reinhart and Kenneth Rogoff have pointed out, since most countries undertook financial liberalization in the 1970s and '80s, there has been a marked increase in the frequency of banking crises. Prior to 1970, bank crises were rare. Between 1970 and 2007, on the other hand, the International Monetary Fund recorded 124 systemic bank crises, 208 currency crises, and sixty-three sovereign debt crises. For modern capitalism, instability has become not the exception, but the rule.

Since the crash, policymakers have focused on improving the regulation of banks and increasing the overall stability of the financial system. But important though this is, it does not address the more fundamental failure of modern capitalist economies to generate enough public and private investment to fuel growth and a sustained level of demand.

The financial crisis exposed the uncomfortable truth that much of the apparently benign growth that had occurred in the previous decade did not in fact represent a sustainable expansion of productive capacity and national income. Rather, it reflected an unprecedented increase in household and corporate debt. Low interest rates and lax lending practices,

Hedge #11, 2010. © Nina Berman.

particularly for land and property, had fuelled an asset price bubble that would inevitably burst. In this sense, the pre-crisis growth of output can be judged only alongside its post-crisis collapse.

Since 2008, most Western economies have gradually returned to economic growth. But the recovery was the slowest in modern times. Output in the United States, France, and Germany did not return to pre-crash levels for fully three years; for the United Kingdom it took more than five. Across most developed economies, unemployment has remained stubbornly above its pre-crisis rate. It was higher in 2014 than in 2007 in twenty-eight countries belonging to the Organization for Economic Cooperation and Development (OECD). Even in countries where unemployment is lower than in 2007, or has been falling since its post-crisis peak, wages have been largely stagnant. In the United Kingdom, where employment has grown, real wages suffered their sharpest decline since records began in 1964.

Underpinning this weak growth pattern has been a dramatic collapse in private-sector investment. Investment as a proportion of GDP had already been falling throughout the previous period of growth. Since 2008 this has

occurred despite the extraordinary persistence of near-zero real interest rates, bolstered in most of the major developed economies by successive rounds of "quantitative easing," through which central banks have sought to increase the money supply and stimulate demand. Yet they have barely succeeded, as continuing low inflation rates have revealed.

The decline in investment is also related to the financialization of the corporate sector. Over the last decade or so, an increasing percentage of corporate profits has been used for share buybacks and dividend payments rather than for reinvestment in productive capacity and innovation. Between 2004 and 2013 share buybacks by Fortune 500 companies amounted to a remarkable $2.4 trillion. In 2014, these companies returned $885 billion to shareholders, more than their total net income of $847 billion.

One result of the decline in investment is that productivity growth has also been weak relative to historic trends. In the decade prior to the crisis, labor productivity growth was below trend in almost all G7 countries, in some continuing a thirty-year decline. Since the financial crisis it has fallen further in the most developed countries, including the United States, Japan, France, and the United Kingdom. At the same time it appears that the growth of innovation that could enhance productivity has also slowed down. All this has led some economists to ask whether Western capitalism has entered a period of "secular stagnation"—a long period of low growth and financial instability.

Stagnant living standards and rising inequality

But weak and unstable growth is only part of modern capitalism's problem. One of the most striking features of Western economies over the last four decades is that, even when growth has been strong, the majority of households have not seen commensurate increases in their real incomes. In the United States, real median household income was barely higher in 2014 than it had been in 1990, though GDP had increased by 78 percent over the same period. Though beginning earlier in the United States, this divergence of average incomes from overall economic growth has now become a feature of most advanced economies.

There are in fact three separate trends here. In most developed countries, the total share of labor (salaries and wages) in overall output has fallen; earnings have not kept pace with gains in productivity; and the distribution of the reduced labor share has become more unequal.

Across advanced economies, the share of GDP going to labor fell by 9 percent on average between 1980 and 2007. Worker pay tended to grow as productivity increased in the post–Second World War years, until the 1970s. But since 1980, labor productivity in the United States has increased by around 85 percent, while compensation has increased by only around 35 percent. Since 1999, the ILO calculates that across thirty-six developed

economies, labor productivity has increased at almost three times the rate of real wage growth.

At the same time as the labor share has been falling, more of it has been going to workers who earn the most and less to those in the middle and at the bottom of the scale. Across advanced economies, higher skilled workers claimed an additional 6.5 percent of the labor share between 1980 and 2001, whereas low-skilled workers saw their portion shrink by 4.8 percent.

Meanwhile, those at the very top of the income distribution have done exceedingly well. In the United States, between 1975 and 2012, the top 1 percent gained around 47 percent of the total increase in incomes. In Canada, over the same period, it was 37 percent, and in Australia and the United Kingdom, over 20 percent. In the United States, the incomes of the richest 1 percent rose by 142 percent between 1980 and 2013 (that is, from an average of $461,910, adjusted for inflation, to $1,119,315) and their share of national income doubled, from 10 to 20 percent. In the first three years of the recovery after the 2008 crash, an extraordinary 91 percent of the gains in income went to the richest 1 percent of the population.

At the same time, most developed countries have seen labor markets become more polarized and insecure. In the decade between the late 1990s and late 2000s, the proportion of low-paid workers increased in most advanced economies. Since the financial crash, unemployment has remained high, particularly among young people. Across the OECD, unemployment in the sixteen-to-twenty-five age group averaged 15 percent in 2014, with over 33 percent in Spain, Portugal, Italy, and Greece. "Non-standard" work (meaning part-time, temporary, and self-employed work, though not all of this is insecure) now accounts for around a third of total employment in the OECD, including half the jobs created since the 1990s and 60 percent since the 2008 crisis. In 2013 almost three in ten part-time workers across the OECD were "involuntary," meaning that they wanted to work full-time but could only find part-time jobs.

The result of these trends has been a rise in inequality across the developed world. Between 1985 and 2013, income inequality increased in seventeen OECD countries, remained relatively constant in four, and decreased in only one (Turkey). Wealth inequality has grown even more than income inequality, a result both of the shift in the distribution of earnings away from wages and toward profits, and of the huge increase in land and property values. In the United Kingdom and the United States over 70 percent of all wealth is now owned by a tenth of the population.

Climate change and environmental risk

Underlying these recent trends in modern capitalism is another, deeper problem: rising greenhouse gas emissions, which have put the world at severe risk of catastrophic climate change.

Climate change poses a unique kind of global threat. The cumulative effect of 200 years of fossil-fuel use for energy in the developed world, now compounded by rapid growth in emerging economies, means that, unless current emissions levels are drastically reduced, the world risks serious damage. At current emissions rates, the earth is on course for an increase in average global temperatures of three to four degrees or more by the end of the century. Even above two degrees of warming the Intergovernmental Panel on Climate Change warns that we can expect a much higher incidence of extreme weather events (such as flooding, storm surges, and droughts). Extreme weather can lead to a breakdown of infrastructure networks and critical services, particularly in coastal regions and cities; lower agricultural productivity, thereby increasing the risk of food insecurity and the breakdown of food systems; increased disease and mortality; greater risks of displacement of peoples and of conflict; and faster loss of ecosystems and species.

In developed economies, as a result both of deindustrialization and recent climate policies, emissions are now declining. But part of this is simply due to the effective transfer of production to the developing world. Western economies are not yet reducing their emissions—either those they generate themselves or those embodied in the goods and services they import—at anything like the speed required to control global warming. Modern capitalism has in effect been storing up profound risks to its own future prosperity and security.

Rethinking economic policy

The problem is that the failings of Western capitalism outlined above are not temporary; they are structural. While this does not mean Western capitalism is doomed to failure, it does mean that the system needs to be rethought. Three key insights can show us how.

First, we need a richer characterization of markets and the businesses within them. It is not helpful to think of markets as pre-existing, abstract entities that economic actors (firms, investors, and households) "enter" to do business, and which require them, once there, to behave in particular ways. Markets are better understood as the *outcomes* of interactions between economic actors and institutions, both private and public. These outcomes will depend on the nature of the actors (for example, the different corporate governance structures of firms); their motivations; the laws, regulations, and cultural contexts that constrain them; and the specific nature of the transactions taking place. Markets are embedded in these wider institutional structures and social, legal, and cultural conditions. In the modern world, as the economist Karl Polanyi once pointed out, the concept of a "free" market is a construct of economic theory, not an empirical observation. Indeed, he observed that the national capitalist market was effectively

forced into existence through public policy—there was nothing "natural" or universal about it.

The ownership and governance structures of corporations are particularly important. Over the last thirty years the view that the maximization of shareholder value would lead to the strongest economic performance has come to dominate business practice, in the United States and the United Kingdom in particular. But for most of capitalism's history, and in many other countries, firms have not been organized primarily as vehicles for the short-term profit maximization of footloose shareholders and the remuneration of their senior executives. Companies in Germany, Scandinavia, and Japan, for example, are structured both in company law and corporate culture as institutions accountable to a wider set of stakeholders, including their employees, with long-term production and profitability as their primary mission. They are equally capitalist, but their behavior is different. Firms with this kind of model typically invest more in innovation than their counterparts who are focused on maximizing shareholder value in the short-term; their executives are paid smaller multiples of their average employees' salaries; they tend to retain for investment a greater share of earnings relative to the payment of dividends; and their shares are held on average for longer by their owners. And the evidence suggests that while their short-term profitability may (in some cases) be lower, over the long term they tend to generate stronger growth. For public policy, this makes attention to corporate ownership, governance, and managerial incentive structures a crucial field for the improvement of economic performance.

Second, we must recognize that investments in technological and organizational innovation, both public and private, are the driving force behind economic growth and development. It has been the main reason for improvements in productivity and consequent rises in living standards for the last 200 years. Thus a theory of how capitalist economies work must include at its center the dynamics of innovation.

The state needs to provide firms incentives that reward long-run perspectives, not short-term financial returns. Innovation requires specific forms of finance: patient, long-term, and committed. This creates a particular role for public banks to steer finance toward long-run projects, leverage private capital, and stimulate multiplier effects. Taxation policies need to encourage long-term investment. Critically, innovation also needs well-funded public research and development institutions, and strong industrial policies. Public funding drove both the IT revolution and other fields such as bio- and nano-technologies, as well as today's green technologies. Each of these has involved both supply-side and demand-side policies, in which new markets as well as new products have been created and public investment has actually stimulated private investment.

Through mission-oriented, strategic public investments, governments can do far more than "level the playing field"—they can help *tilt* the playing

field toward the achievement of goals in the public interest. Just as the creation of the welfare state in the postwar period and the information technology revolution in the decades around the turn of the century unleashed new waves of economic growth and prosperity, public spending today has the potential to catalyse new innovation and mobilize further private investment. Foremost among its priorities must be reducing and eventually eliminating greenhouse gas emissions to limit dangerous climate change, and constraining the economy's wider environmental impacts within biophysical boundaries.

Third, we must recognize that the creation of economic value is a collective process. Businesses do not create wealth on their own. No business today can operate without the fundamental services provided by the state: schools and higher education institutions, health and social care, housing, social security, policing and defence, and the core infrastructures of transport, energy, water, and waste systems. These services and the resources allocated to them are crucial to the productivity of private enterprises. The private sector does not "create wealth" while taxpayer-funded public services simply "consume" it. The state does not simply "regulate" private economic activity. Rather, economic output is *co-produced* by the interaction of public and private actors—and both are shaped by, and in turn help shape, wider social and environmental conditions.

Keynes's analysis of the business cycle was crucial in this regard. His key insight was that private investment is both too volatile and too cyclical—it reinforces its own tendencies to boom and bust. Government investment is thus needed not just to stabilize demand when spending is too low, but to create economic opportunities, and in doing so, increase the willingness of firms to invest. Creating expectations about future growth is a crucial role for government. Indeed Keynes argued that the "socialization of investment"—which could include the public sector acting as investor and equity-holder—would provide more stability to investment and growth.

So the size and functions of the state matter profoundly to the performance of capitalist economies. Contrary to the orthodox view of the state as a "dead hand" impeding free enterprise, successful economies have almost all had states actively committed to their development. This is not just about the role of the state in providing or co-investing in infrastructure (as is sometimes conceded even by those otherwise skeptical of public investment), though this is indeed important. Its role in innovation is also key. At the same time, the development of a skilled and adaptive labor force requires deep investment in education, training, health, childcare, and social care. We need to acknowledge the interdependence of private enterprise and the public sector, of market and non-market activities.

This has an important implication for the role of taxation. Taxation is the means by which economic actors pay the public sector for its contribution to productivity. The orthodox model claims that reducing the share of

taxation in overall economic output will tend to strengthen growth. But if taxation is used productively by an active public sector, the opposite can be the case.

The collective nature of capitalist production makes the distribution of income and wealth an important variable for growth. Shareholders and senior executives—particularly in the financial sector—are extracting unearned rent from the value firms produce. And as the French economist Thomas Piketty has shown, the inheritance of capital (particularly land and property), whose increase in value outpaces that of the economy as a whole, skews the overall distribution of wealth. This has a profound effect on the fairness and inclusivity of today's economies. But it also negatively impacts growth itself. There is striking evidence—confirmed by the OECD and IMF—that economies with more equal distributions of income and wealth have stronger and more stable economic growth than those with greater inequality. In short, redistributive policies that reduce inequality also promote growth.

This creates a powerful case for rebalancing the distribution of earnings between capital and labor. Trade unions have lost power and membership, and deregulated, flexible labor markets have allowed employers to bargain wages and working conditions down. Crucially, raising wages tends to force firms to invest in improving productivity, which in turn boosts economic performance. Public policy therefore has an important role in regulating labor markets, promoting both trade union membership and employee ownership of capital, and managing markets in housing and land. It should also ensure progressive tax systems: of wealth as well as income, and of corporations as well as individuals.

Finally, from an ecological point of view, economic activity generates value by using material resources and energy that are subsequently returned to the environment as waste. Economic growth can be generated either by expanding the use of natural resources or by increasing their economic value. Today, with use of these resources at or close to their safe limits, it matters more than ever which option we choose. In the context of climate change, the centrality of carbon to industrial economies makes an understanding of structural change—not just corrections to marginal market failures—particularly vital to economic analysis.

The role of policy is to help create and shape markets to achieve the co-production, and the fair distribution, of economic value. Economic performance cannot be measured simply by the short-term growth of GDP, but requires better indicators of long-term value creation, social wellbeing, inequality, and environmental sustainability.

Western capitalism has not been functioning well in recent years. Mainstream policies, reflecting an outdated economic orthodoxy, have proved themselves unable to set it on a new course. But there is nothing inevitable about this failure. A more innovative, sustainable, and inclusive economic

system is possible. It will, however, require fundamental changes in our understanding of how capitalism works, and how public policy can help create a different economic future.

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This article is an edited version of the introduction to their co-edited book, Rethinking Capitalism: Economics and Policy for Sustainable and Inclusive Growth *(Wiley Blackwell, 2016).*

Immigration and the Decline of Internationalism in the American Working Class 1864-1919

The first part of this book is based on Charles Leinenweber's 1968 University of California doctoral dissertation.

The Appendix consists of three articles written in the following years which also dealt with the evolution of the American Socialist and Labor movements in the late nineteenth and twentieth centuries.

The history of the political challenges immigration posed for the American movement in this period is relevant today, not only for the American movement but for the labor movement internationally.

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