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—John Gray, *Observer* (UK)

THINGS THEY DON'T TELL YOU ABOUT CAPITALISM

WITH A NEW POSTSCRIPT BY THE AUTHOR

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Conclusion
How to rebuild the world economy

The daunting task ahead of us is to completely rebuild the world economy. Things are not as bad as they were during the Great Depression only because governments have propped up demand through huge deficit spending and unprecedented easing of money supply (the Bank of England has never had a lower interest rate since it was founded in 1644), while preventing bank runs through expansion of deposit insurance and the bailing-out of many financial firms. Without these measures, and the substantial automatic increase in welfare spending (e.g., unemployment benefit), we could be living through a much worse economic crisis than that of the 1930s.

There are people who believe the currently dominant free-market system to be fundamentally sound. They assume that tinkering on the margins will be a sufficient solution to our condition – a bit more transparency here, a tad more regulation there, and a modicum of restraints on executive pay over there. However, as I have tried to show, the fundamental theoretical and empirical assumptions behind free-market economics are highly questionable. Nothing short of a total re-envisioning of the way we organize our economy and society will do.

So what is to be done?

This is not a place to spell out all the detailed proposals required for the reconstruction of the world economy, many of which have been discussed in the foregoing 23 *Things* anyway. Here I will only outline some *principles* – eight of them – that I think we need to have in mind in redesigning our economic system.

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To begin with: paraphrasing what Winston Churchill once said about democracy, let me restate my earlier position that *capitalism is the worst economic system except for all the others*. My criticism is of free-market capitalism, and not all kinds of capitalism.

The profit motive is still the most powerful and effective fuel to power our economy and we should exploit it to the full. But we must remember that letting it loose without any restraint is not the best way to make the most of it, as we have learned at great cost over the last three decades.

Likewise, the market is an exceptionally effective mechanism for coordinating complex economic activities across numerous economic agents, but it is no more than that – a mechanism, a machine. And like all machines, it needs careful regulation and steering. In the same way that a car can be used to kill people when driven by a drunken driver, or to save lives when it helps us deliver an emergency patient to hospital in time, the market can do wonderful things but also deplorable ones. The same car can be made better by putting in improved brakes, more powerful engines or more efficient fuel, and the same market can be made to perform better through appropriate changes to the attitudes of the participants, their motives and the rules that govern it.

There are different ways to organize capitalism. Free-market capitalism is only one of them – and not a very good one at that. The last three decades have shown that, contrary to the claims of its proponents, it slows down the economy, increases inequality and insecurity, and leads to more frequent (and sometimes massive) financial crashes.

There is no one ideal model. American capitalism is very different from Scandinavian capitalism, which in turn differs from the German or French varieties, not to speak of the Japanese form. For example, countries which find American-style economic inequality unacceptable (which some may not) may reduce it through a welfare state financed by high progressive income taxes (as in Sweden) or through restrictions on money-making opportunities themselves by, say, making the opening of large retail stores difficult (as in Japan). There is no simple way to choose between the two, even though I personally think that the Swedish model is better than the Japanese one, at least in this respect.

So capitalism, yes, but we need to end our love affair with unrestrained free-market capitalism, which has served humanity so poorly, and install a better-regulated variety. What that variety would be depends on our goals, values and beliefs.

Second: *we should build our new economic system on the recognition that human rationality is severely limited.* The 2008 crisis has revealed how the complexity of the world we have created, especially in the sphere of finance, has vastly outpaced our ability to understand and control it. Our economic system has had a mighty fall because it was rewired following the advice of economists who believe the human ability to deal with complexity is essentially unlimited.

The new world should be formed with a clear recognition that we have only limited powers of objective reasoning. It is suggested that we can prevent another major financial crisis by enhancing transparency. This is wrong. The fundamental problem is not our lack of information but our limited ability to process it. Indeed, if lack of transparency was the problem, the Scandinavian countries – famously transparent – would not have experienced a financial crisis in the early 1990s. As long as we continue to allow unlimited 'financial innovations', our ability to regulate will always be outstripped by our ability to innovate.

If we are really serious about preventing another crisis like the 2008 meltdown, we should simply ban complex financial instruments, unless they can be unambiguously shown to benefit society *in the long run*. This idea will be dismissed by some as outrageous. It's not. We do that all the time with other products – think about the safety standards for food, drugs, automobiles and aeroplanes. What would result is an approval process whereby the impact of each new financial instrument, concocted by 'rocket scientists' within financial firms, is assessed in terms of risks and rewards to our system as a whole in the long run, and not just in terms of short-term profits for those firms.

Third: while acknowledging that we are not selfless angels, *we should build a system that brings out the best, rather than worst, in people.*

Free-market ideology is built on the belief that people won't do anything 'good' unless they are paid for it or punished for not doing it. This belief is then applied asymmetrically and reconceived as the view that rich people need to be motivated to work by further riches, while poor people must fear poverty for their motivation.

Material self-interest is a powerful motive. The communist system turned out to be unviable because it ignored, or rather wanted to deny, this human driver. This does not, however, prove that material self-interest is our only motive. People are *not* as much propelled by material self-interest as free-market textbooks claim. If the real world were as full of rational self-seeking agents as the one depicted in those textbooks, it would collapse under the weight of continuous cheating, monitoring, punishment and bargaining.

Moreover, by glorifying the pursuit of material self-interest by individuals and corporations, we have created a world where material enrichment absolves individuals and corporations of other responsibilities to society. In the process, we have allowed our bankers and fund managers, directly and indirectly, to destroy jobs, shut down factories, damage our environment and ruin the financial system itself in the pursuit of individual enrichment.

If we are to prevent this kind of thing happening again, we should build a system where material enrichment is taken seriously but is not allowed to become the only goal. Organizations – be they corporations or government departments – should be designed to reward trust, solidarity, honesty and cooperation among their members. The financial system needs to be reformed to reduce the influence of short-term shareholders so that companies can afford to pursue goals other than short-term profit maximization. We should better reward behaviour with public benefits (e.g., reducing energy consumption, investment in training), not simply through government subsidies but also by bestowing it with a higher social status.

This is not just a moral argument. It is also an appeal to enlightened self-interest. By letting short-term self-interest rule everything we risk destroying the entire system, which serves no one's interest in the long run.

Fourth: *we should stop believing that people are always paid what they 'deserve'.*

People from poor countries are, individually, often more productive and entrepreneurial than their counterparts in rich countries. Should they be given equal opportunity through free immigration, these people can, and will, replace the bulk of the workforce in rich countries, even though that would be politically unacceptable and undesirable. Thus seen, it is the national economic systems and immigration control of the rich countries, rather than their lack of personal qualities, that keep poor people in poor countries poor.

Emphasizing that many people stay poor because they do not have true equal opportunity is not to say that they deserve to remain poor insofar as they have had equal opportunity. Unless there is some equalizing in outcome, especially (although not exclusively) so that all children can have more than minimum nutrition and parental attention, the equality of opportunity provided by the market mechanism will not guarantee truly fair

competition. It will be like a race where no one has a head start but some people run with weights on their legs.

At the other end of the spectrum, executive pay in the US has gone into the stratosphere in the last few decades. US managers have increased their relative pay by at least ten times between the 1950s and today (an average CEO used to get paid thirty-five times an average worker's salary then, while today he is paid 300–400 times that), but that is not because their productivity has risen ten times faster than that of their workers. Even excluding stock options, US managers are paid two and a half times what their Dutch counterparts are or four times what their Japanese counterparts are, despite no apparent superiority in their productivity.

Only when we are free to question the hand of cards that the market has dealt us will we be able to find ways to establish a more just society. We can, and should, change the rules of the stock market and the corporate governance system in order to restrain excessive executive pay in limited liability companies. We should not only provide equal opportunity but also equalize, to an extent, the starting points for all children for a truly meritocratic society. People should be given a real, not superficial, second chance through unemployment benefits and publicly subsidized retraining. Poor people in poor countries should not be blamed for their poverty, when the bigger explanations lie in the poverty of their national economic systems and immigration control in the rich countries. Market outcomes are not 'natural' phenomena. They can be changed.

Fifth: *we need to take 'making things' more seriously*. The post-industrial knowledge economy is a myth. The manufacturing sector remains vital.

Especially in the US and the UK, but also in many other countries, industrial decline in the last few decades has been treated as an inevitability of a post-industrial age, if not actively welcomed as a sign of post-industrial success.

But we are material beings and cannot live on ideas, however great the knowledge economy may sound. Moreover, we have always lived in a knowledge economy in the sense that it has always been a command over superior knowledge, rather than the physical nature of activities, that has ultimately decided which country is rich or poor. Indeed, most societies are still making more and more things. It is mainly because those who make things have become so much more productive that things have become cheaper, in relative terms, than services that we think we don't consume as many things as before.

Unless you are a tiny tax haven (a status that is going to become more and more difficult to maintain, following the 2008 crisis), such as Luxemburg and Monaco, or a small country floating on oil, such as Brunei or Kuwait, you have to become better at making things in order to raise your living standard. Switzerland and Singapore, which are often touted as post-industrial success stories, are in fact two of the most industrialized economies in the world. Moreover, most high-value services are dependent (sometimes even parasitic) on the manufacturing sector (e.g., finance, technical consulting). And services are not very tradable, so an overly large service sector makes your balance of payments situation more precarious and thus your economic growth more difficult to sustain.

The myth of the post-industrial knowledge economy has also misdirected our investments. It has encouraged excessive emphasis on, for example, formal education, whose impact on economic growth turns out to be highly complex and uncertain, and on the spread of the internet, whose productivity impacts are actually quite modest.

Investment in 'boring' things like machinery, infrastructure and worker training needs to be encouraged through appropriate changes in tax rules (e.g., accelerated depreciation for machinery), subsidies (e.g., to worker training) or public investment (e.g., redirection into infrastructural development). Industrial policy needs to be redesigned to promote key manufacturing sectors with high scope for productivity growth.

Sixth: *we need to strike a better balance between finance and 'real' activities.*

A productive modern economy cannot exist without a healthy financial sector. Finance plays, among other things, the crucial role of resolving the mismatch between the act of investment and the bearing of its fruits. By 'liquidizing' physical assets whose characteristics cannot be changed quickly, finance also helps us to reallocate resources quickly.

However, in the last three decades, finance has become the proverbial tail that wags the dog. Financial liberalization has made it easier for money to move around, even across national borders, allowing financial investors to become more impatient for instant results. As a consequence, both corporations and governments have been forced to implement policies that produce quick profits, regardless of their long-term implications. Financial investors have utilized their greater mobility as a bargaining chip in extracting a bigger share of national income. Easier movement of finance has also resulted in greater financial instability and greater job insecurity (which is needed for delivering quick profits).

Finance needs to be slowed down. Not to put us back to the days of debtors' prison and small workshops financed by personal savings. But, unless we vastly reduce the speed gap between finance and the real economy, we will not encourage long-term investment and real growth, because productive investments often take a long time to bear fruit. It took Japan forty years of protection and government subsidies before its automobile industry could be an international success, even at the lower end of the market. It took Nokia seventeen years before it made any profit in the electronics business, where it is one of the world leaders today. However, following the increasing degree of financial deregulation, the world has operated with increasingly shorter time horizons.

Financial transaction taxes, restrictions on cross-border movement of capital (especially movements in and out of developing countries), greater restrictions on mergers and acquisitions are some of the measures that will slow down finance to the speed at which it helps, rather than weakens or even derails, the real economy.

Seventh: *government needs to become bigger and more active.*

In the last three decades, we have been constantly told by free-market ideologues that the government is part of the problem, not a solution to the ills of our society. True, there are instances of government failure – sometimes spectacular ones – but markets and corporations fail too and, more importantly, there are many examples of impressive government success. The role of the government needs to be thoroughly reassessed.

This is not just about crisis management, evident since 2008, even in the avowedly free-market economies, such as the US. It is more about creating a prosperous, equitable and stable society. Despite its limitations and despite numerous attempts to weaken it, democratic government is, at least so far, the best vehicle we have for reconciling conflicting demands in our society and, more importantly, improving our collective well-being. In considering how we can make the best out of the government, we need to abandon some of the standard 'trade-offs' bandied about by free-market economists.

We have been told that a big government, which collects high income taxes from the wealthy and redistributes them to the poor, is bad for growth, as it discourages wealth creation by the rich and makes lower classes lazy. However, if having a small government is good for economic growth, many developing countries that

have such a government should do well. Evidently this is not the case. At the same time, the Scandinavian examples, where a large welfare state has coexisted with (or even encouraged) good growth performance, should also expose the limits to the belief that smaller governments are always better for growth.

Free-market economists have also told us that active (or intrusive, as they put it) governments are bad for economic growth. However, contrary to common perception, virtually all of today's rich countries used government intervention to get rich (if you are still not convinced about this point, see my earlier book, *Bad Samaritans*). If designed and implemented appropriately, government intervention can increase economic dynamism by augmenting the supply of inputs that markets are bad at supplying (e.g., R&D, worker training), sharing risk for projects with high social returns but low private returns, and, in developing countries, providing the space in which nascent firms in 'infant' industries can develop their productive capabilities.

We need to think more creatively how the government becomes an essential element in an economic system where there is more dynamism, greater stability and more acceptable levels of equity. This means building a better welfare state, a better regulatory system (especially for finance) and better industrial policy.

Eighth: *the world economic system needs to 'unfairly' favour developing countries.*

Because of the constraints imposed by their democratic checks, the free-market advocates in most rich countries have actually found it difficult to implement full-blown free-market reform. Even Margaret Thatcher found it impossible to consider dismantling the National Health Service. As a result, it was actually developing countries that have been the main subjects of free-market policy experiments.

Many poorer countries, especially in Africa and Latin America, have been forced to adopt free-market policies in order to borrow money from free-market-loving international financial organizations (such as the IMF and the World Bank) and rich-country governments (that also ultimately control the IMF and the World Bank). The weakness of their democracies meant that free-market policies could be implemented more ruthlessly in developing countries, even when they hurt a lot of people. This is the ultimate irony of all – people needing most help were worst hit. This tendency was reinforced by the strengthening of global rules over the last couple of decades on what governments can do to protect and develop their economies (more necessary in the poor countries) through the establishment and/or strengthening of organizations such as the WTO, the BIS and various bilateral and regional free-trade and investment agreements. The result has been a much more thorough implementation of free-market policies and much worse performance in terms of growth, stability and inequality than in developed countries.

The world economic system needs to be completely overhauled in order to provide greater 'policy space' for the developing countries to pursue policies that are more suitable to them (the rich countries have much greater scope to bend, or even ignore, international rules). The developing countries need a more permissive regime regarding the use of protectionism, regulation of foreign investment and intellectual property rights, among others. These are policies that the rich countries actually used when they were developing countries themselves. All this requires a reform of the WTO, abolition and/or reform of existing bilateral trade and investment agreements between rich and poor countries, and changes in the policy conditions attached to loans from international financial organizations and to foreign aid from the rich countries.

Of course, these things are 'unfairly favourable' to the developing countries, as some rich countries would argue. However, developing countries already suffer from so many disadvantages in the international system that they need these breaks to have a hope of catching up.

The eight principles all directly go against the received economic wisdom of the last three decades. This will have made some readers uncomfortable. But unless we now abandon the principles that have failed us and that are continuing to hold us back, we will meet similar disasters down the road. And we will have done nothing to alleviate the conditions of billions suffering poverty and insecurity, especially, but not exclusively, in the developing world. It is time to get uncomfortable.